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1983–84 MISCELLANEOUS TAX BILLS, III: S. 562 and S. 1161

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 562 and S. 1161

JUNE 7, 1983

Printed for the use of the Committee on Finance

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1983-84 MISCELLANEOUS TAX BILLS, III

TUESDAY, JUNE 7, 1983

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood presiding.

Present: Senator Packwood and Senator David Durenberger.

[The committee press release, the bills S. 562 and S. 1161, and the description of the bill by the Joint Committee on Taxation follow:]

[Press Release No. 83-141]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON S. 562 AND S. 1161

Senator Bob Packwood, chairman of the Subcommittee on Taxation and Debt Management, announced today that a hearing will be held on Tuesday, June 7, 1983, on S. 562 and S. 1161.

The hearing will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The following legislative proposals will be considered:

S. 562.—Introduced by Senator Percy for himself and Senator Dixon. S. 562 would authorize the Secretary of the Treasury to grant extensions of the 5-year period within which certain private foundations must dispose of excess business holdings.

S. 1161.—Introduced by Senator Durenberger for himself and others. S. 1161 would amend the Internal Revenue Code of 1954 to treat certain motor vehicle operating leases as leases for Federal income tax purposes.

II

98TH CONGRESS
1ST SESSION

S. 562

To authorize the Secretary of the Treasury to grant extensions of the five-year period within which private foundations must dispose of excess business holdings.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 23, 1983

Mr. PERCY (for himself and Mr. DIXON) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To authorize the Secretary of the Treasury to grant extensions of the five-year period within which private foundations must dispose of excess business holdings.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 4943(c)(6) of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following new paragraph:

"The Secretary, may upon receipt of a written request submitted by a private foundation subject to the 5-year period prescribed by this subsection (c)(6) for disposition of such foundation's excess business holdings, grant to such foundation one or more extensions of such 5-year period. Any such extension shall be granted for such additional period or periods of time as the Secretary determines necessary to permit orderly disposition of such holdings. The Secretary in granting or denying an extension shall consider, among other factors, the following:

"(I) Whether the private foundation has in good faith taken reasonable steps to dispose of such holdings throughout the initial 5-year period;

"(II) Whether orderly disposition of such holdings can reasonably be expected to occur before the expiration of the extension period; and

"(III) All other facts and circumstances which the Secretary considers relevant, including size of such holdings relative to enterprises engaged in a comparable trade or business, possible adverse economic impact caused by forced disposition of such holdings, litigation pending against the private foundation or regulations prescribed by any governmental body, either of which may inhibit or prevent disposition, and the recommendation of the Attorney General of the State of incorporation or State of principal office of the private foundation (or other State official having statutory jurisdiction over administration and supervision of the private foundation) that such extension be granted.

Any extension so granted shall be no less than 24 months in duration. An initial extension may be granted by the Secretary immediately upon enactment of this statute. For purposes of any extension granted pursuant to this paragraph, the private foundation's interest in the business enterprise whose holdings constitute excess business holdings shall be the stock or other interest in the business enterprise or in any of its subsidiaries immediately prior to the granting of such extension.".

○

98TH CONGRESS
1ST SESSION

S. 1161

To amend the Internal Revenue Code of 1954 to make it clear that certain motor vehicle operating leases are leases.

IN THE SENATE OF THE UNITED STATES

APRIL 27 (legislative day, APRIL 26), 1983

Mr. DURENBERGER (for himself, Mr. BENTSEN, Mr. SYMMS, Mr. PRYOR, Mr. WALLOP, Mr. MOYNIHAN, and Mr. BOREN) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to make it clear that certain motor vehicle operating leases are leases.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 7701 of the Internal Revenue Code of 1954 (relating to definitions) is amended by relettering subsection (d) as (e) and by inserting after subsection (c) the following new subsection:

"(d) MOTOR VEHICLE OPERATING LEASES.—

"(1) IN GENERAL.—For purposes of this title, the fact that a motor vehicle operating agreement contains a terminal rental adjustment clause shall not be taken into account in determining whether such agreement is a lease.

"(2) DEFINITIONS.—For purposes of paragraph (1)—

"(A) The term 'motor vehicle operating agreement' means any agreement with respect to a motor vehicle (including a trailer) under which the lessor—

"(i) is personally liable for the repayment of, or

"(ii) has pledged property (but only to the extent of the net fair market value of the lessor's interest in such property), other than property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement, as security for,

all amounts borrowed to finance the acquisition of property subject to the agreement.

"(B) The term 'terminal rental adjustment clause' means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property."

SEC. 2. The amendment made by the first section of this Act shall apply whether the agreement was entered into before or after the enactment of this Act.

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DESCRIPTION OF TAX BILLS
(S. 562 and S. 1161)

RELATING TO

EXTENSION OF TIME TO DISPOSE OF EXCESS BUSINESS HOLDINGS AND DEFINITION OF MOTOR VEHICLE OPERATING LEASE

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON JUNE 7, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Finance Subcommittee on Taxation and Debt Management has scheduled a public hearing on June 7, 1983, on two bills: (1) the extension of time for private foundations to dispose of post-1969 acquisitions by gift or bequest of excess business holdings (S. 562—introduced by Senators Percy and Dixon) and (2) the treatment of certain motor vehicle operating agreements as leases (S. 1161—introduced by Senators Durenberger, Bentsen, Symms, Pryor, Wallop, Moynihan, Boren, Mitchell, Matsunaga, and Armstrong).

The first part of this pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, explanation of provisions, and effective dates.

I. SUMMARY

1. S. 562—Senators Percy and Dixon

Extension of Time for Private Foundations to Dispose of Post-1969 Acquisitions by Gift or Bequest of Excess Business Holdings

The Tax Reform Act of 1969 imposed a series of regulatory excise taxes on private foundations. One of the regulatory excise taxes applies if a private foundation acquires more than a permitted level of holdings in a particular business enterprise (known as excess business holdings). However, if a private foundation receives excess business holdings by gift or bequest, rather than by purchase, the 1969 Act provided that the private foundation has 5 years to dispose of the excess business holdings before the regulatory excise tax will apply.

The bill would grant the Internal Revenue Service the authority to grant extensions of time to dispose of excess business holdings acquired by gift or bequest after 1969. Extensions must be a minimum of 24 months.

2. S. 1161—Senators Durenberger, Bentsen, Symms, Pryor, Wallop, Moynihan, Boren, Mitchell, Matsunaga, and Armstrong

Treatment of Certain Motor Vehicle Operating Agreements as Leases

Under present law, the determination of whether a transaction is a lease, in which the lessor of the property is the owner for Federal income tax purposes and entitled to ACRS deductions and investment credits, or a financing arrangement or conditional sale, in which the user is considered the owner, generally requires a case-by-case analysis of all facts and circumstances. Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the presence of a terminal rental adjustment clause in a motor vehicle lease was taken into account in determining whether the nominal lessor would be treated as the owner for Federal income tax purposes. Section 210 of TEFRA prevents the Internal Revenue Service from retroactively denying lease treatment for motor vehicle leases by reason of the presence of a terminal rental adjustment clause. The provision is limited to operating leases in which the vehicle is used by the lessee for business purposes. Since enactment of TEFRA, the Internal Revenue Service has issued proposed regulations denying lease treatment on a prospective basis for a motor vehicle agreement that contains a terminal rental adjustment clause.

The bill would provide that the presence of a terminal rental adjustment clause in a motor vehicle operating agreement shall not be taken into account in determining whether the agreement is a lease, regardless of whether it was entered into before or after enactment of this bill and regardless of whether the vehicle is used by the lessee for business or personal purposes.

II. DESCRIPTION OF BILLS

1. S. 562—Senators Percy and Dixon

Extension of Time for Private Foundations to Dispose of Post-1969 Acquisitions by Gift or Bequest of Excess Business Holdings

Present Law

The Tax Reform Act of 1969 imposed a series of regulatory excise taxes on private foundations. One of the regulatory excise taxes is imposed if a private foundation acquires more than a permitted level of holdings in a business enterprise (called excess business holdings).

Under those provisions (Code sec. 4943), the regulatory excise tax applies if the private foundation and all disqualified parties together hold 20 percent or more of the stock or other interest in the enterprise. If an unrelated party has effective control of the enterprise, then the regulatory excise tax is imposed only where the private foundation and all disqualified persons own 35 percent or more of the enterprise. However, there are no excess business holdings if the private foundation owns not more than 2 percent of the voting stock and not more than 2 percent of the value of all outstanding shares of all classes of stock, regardless of the ownership by disqualified persons.

If the private foundation has excess business holdings, an excise tax equal to 5 percent of the value of the excess business holdings is imposed. If the excess business holdings are not disposed of by the end of a correction period, a 200 percent excise tax is imposed.

If a private foundation acquires, after May 26, 1969, holdings in an enterprise other than by purchase (such as by gift or bequest), that acquisition does not create excess business holdings for a period of 5 years after that acquisition. In essence, this rule provides private foundations a period of 5 years to dispose of excess business holdings acquired by gift or bequest.

Explanation of the Bill

The bill would grant the Internal Revenue Service the power to grant one or more extensions of time (after expiration of the 5-year period provided by present law) to dispose of holdings in an enterprise acquired by gift or bequest after May 26, 1969, before the tax on excess business holdings would apply to such acquisitions. Any extensions which are granted would be for a period or periods which the Internal Revenue Service determines to be necessary to permit orderly dispositions of such holdings, except that any extension must be at least 24 months.

The bill would provide that the Internal Revenue Service is to take into account the following series of factors in determining whether to grant an entension:

(1) whether the private foundation has in good faith taken reasonable steps to dispose of the holdings;

(2) whether orderly disposition of the holdings can reasonably be expected to occur before the expiration of the extension period;

(3) the size of the holdings relative to other enterprises engaged in a comparable trade or business;

(4) the possible adverse economic impact caused by forced disposition of the holdings;

(5) any litigation pending against the private foundation or regulations prescribed by any governmental body which may inhibit or prevent disposition;

(6) the recommendation of the State Attorney General having jurisdiction over the private foundation; and

(7) all other facts and circumstances the Internal Revenue Service considers relevant.

The bill would provide that any initial extension may be granted immediately upon enactment of the bill. For purposes of any extention granted under the bill, the private foundation's interest in the business enterprise whose holdings constitute excess business holdings would be the stock or other interest in the business enterprise or in any of its subsidiaries immediately prior to the granting of the extension.

While the provisions of the bill would apply to any private foundation receiving excess business holdings by gift or bequest, one of the beneficiaries of the bill is expected to be the John D. and Cathrine T. MacArthur Foundation of Chicago, Illinois.

Effective Date

The bill would be effective on the date of enactment.

2. S. 1161—Senators Durenberger, Bentsen, Symms, Pryor, Wallop, Moynihan, Boren, Mitchell, Matsunaga, and Armstrong

Treatment of Certain Motor Vehicle Operating Agreements as Leases

Present Law

General rules

Cost recovery (ACRS) deductions and investment credits are allowed for property that is used for a business or other income-producing purpose. These tax benefits generally are allowed only to the person who is, in substance, the owner of the property. If the property is used in a transaction considered a lease for Federal income tax purposes, the lessor is treated as the owner entitled to ACRS deductions and investment credits. If the property is used in a transaction considered a financing arrangement or conditional sale, the user of the property is considered the owner for Federal income tax purposes. In general, the determination of whether a transaction is a lease or a conditional sale requires a case-by-case analysis of all facts and circumstances.

Although the determination of whether a transaction is a lease is inherently factual, a series of general principles is embodied in court cases, revenue rulings, and revenue procedures. Under these general principles, the lessor has to show that the property is being used for a business or other income-producing purpose. To establish a business purpose, the lessor must have a reasonable expectation that he will derive a profit from the transaction, independent of tax benefits.[1] This requirement precludes lease treatment for a transaction that is intended merely to reduce the user's costs by utilizing the lessor's tax base.

However, the fact that the lessor can show a business purpose does not automatically result in lease treatment, since a profit motive also exists in a financing arrangement. In addition, the lessor has to retain meaningful benefits and burdens of ownership.[2] Thus, lease treatment could be denied if the user of the property has the option to purchase the property at the end of the lease for a price that is nominal in relation to the value of the property at the time of exercise (as determined at the time the parties entered into the transaction) or for a price that is relatively small when compared with the total payments required to be made.[3]

Where the residual value to the lessor is nominal, the lessor may be viewed as having transferred full ownership of the property for the rental fee. Where the price under a purchase option is more than nominal but low in comparison to fair market value, the lessor may be viewed as having transferred full ownership because of the likelihood that the lessee will exercise the bargain purchase option.[4] Further, if the nominal lessor of property has a contractual right to require the nominal lessee to purchase the property (a "put"), the transaction could be denied lease treatment because a put eliminates the risk borne by owners of property in connection with fluctuations in the residual value of property and risks that there will be no market for the property at the end of the lease term.

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[1] *See Hilton* v. *Commissioner,* 74 T.C. 305 (1980) *aff'd,* 671 F.2d 316 (9th Cir. 1982).
[2] *See Frank Lyon Co.* v. *United States,* 435 U.S. 561 (1978), *rev'g,* 536 F.2d 746 (8th Cir. 1976).
[3] *See* Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

Terminal rental adjustment clauses

Lease agreements in the motor vehicle industry often contain a terminal rental adjustment clause. A terminal rental adjustment clause permits (or requires) an upward or downward adjustment of rent to make up for any difference between the projected value of a vehicle and the actual value upon lease termination.

TEFRA

The Internal Revenue Service has taken (and continues to take) the position that the presence of a terminal rental adjustment clause in a motor vehicle lease would cause the transaction to be treated as a conditional sale for tax purposes. However, section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) prevents the Internal Revenue Service from retroactively denying lease treatment for certain motor vehicle leases, including leases of trailers, by reason of the fact that those leases contain terminal rental adjustment clauses.

Section 210 of TEFRA does not address the legal effect of terminal rental adjustment clauses, nor does it prevent the issuance of regulations addressing the legal effect of these clauses on a prospective basis. The TEFRA provision applies only to operating leases in which the lessee uses the property for business, as opposed to personal, purposes. For this purpose, a lease is an operating lease if the lessor acquires the property with cash or recourse indebtedness. Thus, the provision does not apply to leveraged leases financed with nonrecourse debt.

On November 23, 1982, after the enactment of TEFRA, the Internal Revenue Service issued proposed regulations on a prospective basis that address the legal effect of a terminal rental adjustment clause. Under the proposed regulations, the presence of a terminal rental adjustment clause would indicate that a motor vehicle agreement is not a lease.

Swift Dodge

Prior to the enactment of TEFRA, the Tax Court addressed the legal effect of terminal rental adjustment clauses in motor vehicle leases in the case of *Swift Dodge* v. *Commissioner.*[5] In *Swift Dodge*, an automobile dealership, which operated a separate leasing business, acquired most of its cars for lease by borrowing amounts from banks on a recourse basis. The Tax Court held that these nonleveraged transactions were leases and not conditional sales. However, after the enactment of TEFRA, the Ninth Circuit Court of Appeals reversed the Tax Court, holding that a lease containing a terminal rental adjustment clause was, in substance, a conditional sale to the lessee.[6] The Court of Appeals concluded that, because the lessee bore the risk of loss and, by virtue of the terminal rental adjustment clause, bore the risk of fluctuation in value, the only significant risk borne by the lessor was the risk of default by the lessee, a risk assumed by any holder of a security interest in a conditional sale.

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[4] *See M&W Gear Co.* v. *Commissioner*, 446 F.2d 841 (7th Cir. 1971).

[5] 76 T.C. 547 (1981).

Explanation of the Bill

The bill would provide that the presence of a terminal rental adjustment clause in a motor vehicle operating agreement shall not be taken into account in determining whether an agreement is a lease.

The bill would apply to operating leases of motor vehiles (including trailers) in which the lessee uses the property for business or personal purposes. However, the bill would not apply to leveraged leases financed with nonrecourse debt.

Effective Date

The provisions of the bill would apply to agreements entered into before or after the enactment of the bill.

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[6] 696 F.2d 651 (9th Cir. 1982), rev'g, 76 T.C. 547 (1981).

Senator PACKWOOD. The hearing will come to order, please. We have hearings on two bills today, S. 562 and S. 1161. The statements of all of the witnesses will be placed in the record, and I would ask that those statements be abbreviated and make your main points orally rather than reading your statement.

Ms. Jackie Levinson is here on behalf of the Treasury Department to testify on both bills. I believe, Miss Levinson, this is the first time you have been here.

Ms. LEVINSON. Yes, sir.

Senator PACKWOOD. We don't hold Treasury to the 5-minute rule because you have got to comment on all of the bills, although I might add we only have two bills. And I would appreciate it if you do not read your entire 10-page statement but emphasize your main points.

Ms. LEVINSON. Yes. I will submit the written statements for the record and make some oral remarks.

Senator PACKWOOD. Why don't you go right ahead.

[The prepared written statement of Ms. Levinson follows:]

For Release Upon Delivery
Expected at 9:30 a.m. EDT
June 7, 1983

STATEMENT OF
JACKIE S. LEVINSON
DEPUTY TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Treasury Department on S. 1161, which would guarantee lease treatment for Federal income tax purposes to certain motor vehicle operating agreements, and on S. 562, which would authorize the Internal Revenue Service to grant extensions of the 5-year period within which certain private foundations must dispose of excess business holdings.

The Treasury Department opposes S. 1161. The Treasury Department also opposes S. 562 as currently drafted, but we would not oppose a provision permitting extension of the 5-year disposition period under more limited circumstances.

S. 1161
Guarantee of Lease Treatment for Certain Motor Vehicle Operating Agreements

Background

There are two basic types of motor vehicle operating agreements -- "closed end" and "open end". In a typical open end agreement, a provider of vehicles, for example, an automobile dealership, agrees to acquire certain makes and models of vehicles for use by its customer. The agreement generally will have a term of 24 to 36 months. Under the agreement, the customer performs all necessary maintenance and repairs to the vehicle and pays the dealer a monthly charge sufficient to cover the expected economic depreciation on the vehicle, insurance in favor of the dealer, license and registration fees, sales taxes, and any other miscellaneous costs imposed upon the owner of the vehicle. An open end agreement also will contain a provision known as a "terminal rental adjustment clause."

A terminal rental adjustment clause ("TRAC clause") in the usual case will provide that upon the normal termination of the agreement, the vehicle subject to the agreement is to be sold (or offered for sale) to a third party. If the proceeds from this sale are less than an estimate of the value of the vehicle as stipulated in the agreement (which is generally the projected "blue book" value of the vehicle on the termination date of the agreement), the customer is obligated to pay the difference to the dealer. If the sale proceeds equal the stipulated value, no further payment is due. Finally, the agreement will provide either that the dealer will retain any excess of the sale proceeds over the stipulated value or that the dealer must remit the excess to its customer, directly with a cash refund or indirectly by crediting the customer's payments under a new agreement.

A closed end agrsement differs from an open end agreement in one important respect. Unlike an open end agreement, closed end agreements do not contain TRAC clauses. Thus, the dealer under a closed end agreement bears the risk that the value of the vehicle at the normal end of the agreement will be less than its projected value.

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), the status for Federal tax purposes of a motor vehicle operating agreement either as a lease, a loan, or a conditional sale, was determined from all the facts and circumstances. Whether an agreement is a lease or a sale is important because it determines which party -- the dealer or the customer -- is the owner of the vehicle for Federal tax purposes and thus is entitled to claim depreciation and investment tax credit with respect to the vehicle.

If an agreement is considered a lease for Federal tax purposes, then the dealer, as lessor, is entitled to claim the tax benefits associated with the vehicle and must report the periodic payments it receives from the customer as rental income. On the other hand, if an agreement is treated as a loan or a conditional sale, the customer is considered the tax owner of the property. The customer is then entitled to claim any depreciation and investment credit with respect to the vehicle if it is used in a trade or business and may deduct any interest expense that is part of the financing transaction.

In 1979 the Internal Revenue Service issued a technical advice memorandum in which it concluded that a standard open end motor vehicle operating agreement was a conditional sale and not a lease. This position was ultimately sustained in the case of Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), rev'g 76 T.C. 547 (1981), where the Court of Appeals for the Ninth Circuit found that there were "no essential differences between [the transactions under review] and a conditional installment sale with a lump sum final payment."

Between the time of the Tax Court's decision in Swift Dodge and the Ninth Circuit's reversal, Congress enacted section 210 of TEFRA. That section generally provides that until the Treasury Department publishes a regulation stating that an agreement containing a TRAC clause is not a lease for Federal tax purposes, the existence of a TRAC clause is not to be taken into account in deciding whether such an agreement is a lease. This provision essentially guarantees lease treatment for open end motor vehicle agreements entered into before a regulation is published. Under the TEFRA provision, the guarantee of lease treatment applies only if the lessee uses the property in a trade or business or for the production of income.

On November 23, 1982, the Treasury Department published a proposed regulation that would deny lease treatment to motor vehicle operating agreements with TRAC clauses. A public hearing on the regulation was held on February 10, 1983. A final regulation has not yet been published.

S. 1161

S. 1161 would continue permanently the guarantee of lease treatment to open end motor vehicle operating agreements by requiring that terminal rental adjustment clauses be ignored in determining whether the agreements are leases. S. 1161 also would extend lease treatment to open end agreements with customers that use the vehicles for nonbusiness, personal purposes. The term "motor vehicle" is not defined.

Discussion

The Treasury Department opposes the enactment of S. 1161. In our view, open end leases are clearly conditional sales for tax purposes. While the Treasury has, in the last two years, supported leasing as an efficient means for transferring tax benefits, we see no justification for favoring motor vehicles over other equipment that is often leased, such as railroad boxcars, ships, and airplanes.

Open end leasing efficiently transfers tax benefits because the price paid by the lessee reflects the fact that the lessor is insulated against any decline in the value of the leased property. The only risk borne by a dealer under a motor vehicle trac clause agreement is the risk that the customer will default on its obligation under the agreement. however, as correctly observed by the Ninth Circuit in the Swift Dodge case, this risk is exactly the same as the risk assumed by a lender making a loan secured by property to one of its customers. In such a case, the law is clear that the lender is not the owner of the property for tax purposes.

As the controversy over safe harbor leasing has highlighted, there is a tension between the idea that tax benefits should be transferred and the traditional tax theory that substance should govern over form. Congress has addressed this issue both in 1981 and in 1982. Safe harbor leasing, enacted in the Economic Recovery Tax Act of 1981, allowed lessors to be treated as owners of leased property for Federal tax purposes under certain agreements that would not have been characterized as leases previously. Under TEFRA in 1982, safe harbor leasing was repealed generally beginning in 1984 and was restricted in the interim. In its place, Congress substituted finance leases, which adhere much more closely to leases prior to safe harbor leasing.

In the leasing amendments made by TEFRA, Congress specifically recognized that the Treasury could promulgate regulations concerning TRAC clauses and their effect on the characterization of motor vehicle operating agreements. In context, section 210 of TEFRA was part of larger changes in the leasing area, all of which limited the transferability of tax benefits by requiring leases to contain traditional lease characteristics. We agree with the decision of the Ninth Circuit in Swift Dodge that when the terms of open end leases are closely scrutinized, it is clear that they are not leases. Any argument that open end leases should be treated as leases and not as conditional sales must, therefore, rest on other factors.

Since publication of the proposed regulations, we have carefully considered the major arguments advanced by the motor vehicle lessors for treating open end agreements as leases. In our deliberations, we have reached the conclusion that these arguments do not justify giving the motor vehicle leasing industry preferential treatment over other industries.

The first argument made by the industry is that open end leases lower the cost of the property to the customer. This assertion is not true. In a true lease, the customer compensates the lessor for assuming the risk that the property will go down in value. In an open end lease, the customer assumes that risk, so the customer does not pay the lessor for it. Because of the customer's assumption of risk, the stream of "rents" under a TRAC lease are less than those under a true lease. However, because the customer bears the risk of loss, the total cost of the property to the customer will not be reduced; if the value of the property declines below the estimated value, the loss, when added to the rents, should approximate the cost to the customer under a closed end agreement.

A second point made by the industry is that open end agreements are not motivated by tax avoidance and that both parties to these agreements have consistently treated the transactions as leases. They argue that the IRS has not been whipsawed by the parties' taking inconsistent positions. On this point, there is only anecdotal evidence. A dealer would not know how its customers reported the transaction without examining each customer's tax return. Even if consistent positions are always taken, however, transactions between business taxpayers may be motivated by tax considerations if the tax benefits of ownership are less valuable to the customer than to the lessor.

Next, the industry justifies a special exception for motor vehicles on the grounds that the tax treatment of open end agreements is long established and that the practice in the industry was tacitly approved by IRS and Treasury. This is simply not true. Prior to 1979 the Service's position with respect to these agreements may not have been articulated in a published ruling. However, records of past meetings between the Treasury, the IRS, and the motor vehicle leasing industry show that strong reservations were expressed by IRS and Treasury personnel about whether open end agreements were leases. Members of the industry have proceeded in the face of those warnings. Any hardship that might occur by disrupting past transactions was resolved in TEFRA. For the future, the industry should have to comply with the same set of rules that govern the airlines, the steel industry, the paper companies, the mining industry, and other industries, all of which would greatly appreciate the opportunity to use open end agreements with impunity.

We have no doubt that final regulations will change the business practices of the motor vehicle leasing industry, and we recognize that there could be some disruptions in the short run as the industry adjusts to the rules in the regulation. But if the dealers in fact provide valuable services to their customers (other than merely providing financing for the vehicle), that business will continue in an altered form. In any case, the tax incentives provided by the investment credit and ACRS will continue to be available when vehicles are used for business purposes.

Finally, the industry has argued that the revenue to be gained from the issuance of the proposed regulations is relatively small. We agree that the issues in S. 1161 should not be settled on the basis of revenue estimates.

Let me emphasize that we are not opposed to statutory rules that would improve the efficiency of transferring tax benefits. What we oppose is the special status that S. 1161 would confer upon the motor vehicle leasing industry relative to other industries. We think that it is impossible to draw this line with any justification. Indeed, this bill itself would extend lease treatment to open end agreements with respect to motor vehicles other than automobiles.

S. 1161 also extends lease treatment to open end operating agreements with respect to vehicles that are not used in a trade or business or for the production of income. In this situation, the investment credit and accelerated cost recovery allowances are not available if the transaction is cast as a conditional sale so that the customer is considered the owner of the vehicle for tax purposes.

The industry agrees that tax benefits would be disallowed in this case but argues that no tax avoidance is present because the customer, as the purchaser of the vehicle, would be entitled to an interest deduction for a portion of the payments he makes to the lessor. This argument is beside the point. The subsidy in the investment credit and ACRS deductions is given to business property. The fact remains that treating the agreement as a lease results in available investment credit and ACRS deductions when the owner of a vehicle uses it for personal purposes. We thus oppose extending lease treatment to operating agreements where the vehicles (or other equipment) are not used in a trade or business or for the production of income.

S. 562
Authority to Extend the Five-Year Period for Disposition of Excess Business Holdings Acquired by Gift or Bequest

Background

As part of the Tax Reform Act of 1969, Congress enacted section 4943, which limits to certain prescribed percentages the holdings that a private foundation, in combination with certain related persons, may own in an active business enterprise. A penalty tax of 5 percent is imposed on the value of any holdings of a private foundation in excess of the permitted holdings. An additional penalty tax of 200 percent is imposed on the value of the excess business holdings that are not disposed of before the earlier of the date of mailing of a notice of deficiency with respect to the 5 percent tax or the date of assessment of the 5 percent tax.

Transitional rules allow a substantial period of time for a private foundation that had excess business holdings on May 26, 1969, to reduce its holdings to the permitted levels. In addition, the statute provides a five-year period for disposition of excess business holdings which result from a change in holdings, other than through a purchase by the foundation or related persons, that occurs after May 26, 1969. The five-year disposition provision thus governs gifts or bequests of stock to private foundations. When section 4943 was enacted, it was expected that five years would be sufficient time to allow orderly disposition by a private foundation of excess business holdings received by gift or bequest.

S. 562

S. 562 would authorize the Secretary of the Treasury to extend the five-year period for disposition of excess business holdings acquired by gift or bequest for such additional periods of time as the Secretary determines are necessary to permit orderly disposition of such holdings. In granting or denying a request for such an extension, the Secretary would consider: (1) whether the private foundation has in good faith taken reasonable steps to dispose of such holdings throughout the initial five-year period; (2) whether orderly disposition of such holdings can reasonably be expected to occur before the expiration of the extension period; and (3) all other facts and circumstances which the Secretary considers relevant, including the size of the holdings relative to enterprises engaged in a comparable trade or business, possible adverse economic impact caused by forced disposition of such holdings, litigation pending against the private foundation or regulations prescribed by any governmental body, either of which may inhibit or prevent disposition, and the recommendation of the Attorney General of the State of incorporation or State of principal office of the private foundation that such extension be granted. Under the bill any extension would be granted for no less than 24 months. For purposes of any extension, the private foundation's holdings would be the stock or other interest in the business enterprise or any of its subsidiaries immediately prior to the granting of the extension.

Discussion

We understand that S. 562 has been introduced to provide relief for the John D. and Catherine T. MacArthur Foundation. On December 1, 1978, the MacArthur Foundation received a bequest from John D. MacArthur of 100 percent of the stock of Bankers Life and Casualty Company ("Bankers"). The stock was valued at approximately $700 million at the time of the bequest. Bankers is the parent corporation of an affiliated group that includes approximately 60 corporations. Bankers and its affiliated corporations are engaged primarily in the life and accident and health insurance businesses and in real estate operations. Bankers is one of the largest independent underwriters of individual accident and health policies. It has been represented that Bankers' accident and health operations are twice as large as any business of that type which has been sold in the past.

Despite significant efforts to dispose of its Bankers stock, the MacArthur Foundation believes that it is extremely unlikely that it will be able to comply with the excess business holdings divestiture requirements before December 1, 1983, the end of the five-year disposition period under the statute. The primary reason given for the inability to comply with the statute is the size and complexity of the combined insurance and real estate operations owned by Bankers. Other factors that the MacArthur Foundation considers significant are the economic conditions that existed during the five-year disposition period, regulatory restrictions applicable to the insurance industry, uncertainty in the accident and health insurance industry, the combination of two distinct and substantially unrelated operations (insurance and real estate) in one corporation, and the diversity and extent of the real estate operations. According to the MacArthur Foundation, these factors contributed to the failure of its attempts to locate a single buyer for its Bankers stock.

After carefully considering the situation of the MacArthur Foundation, the Treasury Department has concluded that it may be one of a limited number of cases in which five years is not adequate for the orderly disposition of excess business holdings received by gift or bequest. In such situations, it appears appropriate to provide some means for extending the five-year disposition period.

The Treasury Department's opposition to S. 562 is based on our concern that it provides insufficient standards to limit the grant of extensions to those situations which we think deserve relief. While S. 562 lists a number of factors to be considered by the Secretary in granting or denying an extension, none of these factors is actually a prerequisite to obtaining an extension. In addition, S. 562 would permit repeated extensions, apparently without limit.

We believe that extensions should be allowed only where a foundation has made every effort to dispose of its excess business holdings within the five-year period and has been unable to do so because of unusual circumstances. However, we do not believe that economic conditions and financial decisions made by foundation managers should be considered grounds for an extension. For example, a foundation manager may decide to retain stock until economic conditions improve so that it may be sold at a higher price. Similarly, for stock that trades in a very thin market, a foundation that delays disposition until the end of the disposition period may be at a bargaining disadvantage because potential buyers are aware that disposition must be made before a specific date. Except in unusual circumstances, we believe that five years is long enough for a foundation to divest itself of stock received by gift or bequest. The consequences of decisions to delay should generally rest with the foundation managers and should not be the basis for an extension of the disposition period.

For these reasons, we believe any extension of the period for disposing of excess business holdings received as a gift or bequest should be limited to situations in which certain specific criteria are satisfied. These criteria should include, at a minimum, findings by the Secretary that: (1) diligent efforts to dispose of the holdings were made throughout the initial five-year period; (2) disposition within the initial five-year period is not possible, except at a price substantially below current fair market value, because of the existence of one or more specified factors; (3) the foundation has submitted a realistic plan to dispose of the holdings within the extension period; and (4) each State Attorney General (or other State official) having administrative or supervisory authority or responsibility with respect to the foundation's disposition of the excess business holdings has reviewed the plan for disposition and does not object to it. The specific factors that we would suggest justify an extension include an unusually large gift or bequest of business holdings in which the business is particularly diverse or the corporate structure is unusually complex, limitations imposed by statute or regulations prescribed by any governmental body that effectively prevent disposition of the excess business holdings, and any court order which effectively prevents disposition of the excess business holdings for more than 2 years during the five-year period. Poor economic conditions during the five-year period would not be considered sufficient to justify an extension. Economic conditions affect the current value of a foundation's holdings, not its ability to dispose of those holdings at current value.

We further suggest that the Secretary have the authority to grant only one extension for five years. As discussed above, the bargaining position of a foundation can be affected by the approach of a disposition deadline. We believe foundation managers can deal with this problem most effectively if they are given a fixed deadline that is reasonably distant. The availability of repeated extensions might influence a foundation manager's decision to delay disposition until the end of the disposition period, with the undesirable result that the foundation would either need another extension or would be placed in a weak bargaining position. On the other hand, it is questionable whether an extension granted for only two years would provide a deadline sufficiently far in the future to allow a foundation manager a reasonable amount of flexibility in disposing of excess business holdings. We believe that an extension of five years should place a foundation in a reasonable bargaining position and that a total of ten years should be sufficient time for disposition of any excess business holdings received by gift or bequest.

Finally, I would like to comment on the provision of S. 562 that states that, for purposes of the extension, the foundation's excess business holdings should be the stock or other interest in the business enterprise or in any of its subsidiaries immediately prior to the granting of an extension. The issue of whether stock of subsidiaries is constructively owned by a foundation owning stock of the parent corporation and the treatment of stock received in corporate reorganizations, adjustments, or acquisitions as excess business holdings, have been the subject of great controversy, particularly under the transition rules for interests owned in 1969. We are very close to issuing final regulations in this area, which we believe will adequately resolve these issues. In view of the substantial time, effort, and consideration that have already gone into reaching a resolution of these difficult issues, we favor leaving to regulations the treatment of stock of subsidiaries and stock received in reorganizations for purposes of the gift and bequest rules, rather than introducing a separate set of rules at this time.

To summarize, the Treasury Department is not opposed to a narrowly drawn provision which authorizes extensions, under limited, specified circumstances, of the five-year period for disposition of excess business holdings received by gift or bequest. However, we consider the provisions of S. 562 to be too broad to be administrable. Therefore, we oppose S. 562 as currently drafted.

STATEMENT OF HON. JACKIE LEVINSON, ASSOCIATE TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Ms. LEVINSON. Thank you, Mr. Chairman.

S. 1161 deals with terminal rental adjustment clauses in motor vehicle operating agreements. We oppose S. 1161. S. 562 deals with extensions of the time within which a private foundation can divest itself of stock received by gifts or bequests. We oppose S. 562 as currently drafted, and we have suggestions as to how we think the provision should be written.

I will first address S. 1161. S. 1161 deals with open end motor vehicle operating agreements that contain terminal rental adjustment clauses or so-called TRAC clauses. In these agreements, the customer maintains the vehicle, makes payments that cover the economic depreciation, insurance and other costs in owning the vehicle. And at the end of the lease, the car, or automobile, is sold to a third party, and the customer then pays the dealer either the deficiency, if the sales proceeds are less than a stipulated value in the agreement, or the customer keeps any profit above the stipulated value in the agreement.

Terminal rental adjustment clauses are not new to Treasury. We have been meeting intermittently with the industry for over 10 years, and the issue is always the same, whether the terminal rental adjustment clause converts the agreement into a conditional sale or whether the agreement is a lease. The consequences of that characterization determine who is to take the tax benefits, the investment credit, and the depreciation on the automobile.

Senator PACKWOOD. Let me interrupt you. I don't understand how, if it is open ended, it becomes a sale. Isn't that what you said?

Ms. LEVINSON. Yes. It is our position that these contracts are conditional sale contracts.

Senator PACKWOOD. But not a conditional sale to the person that is renting the car.

Ms. LEVINSON. Yes. That is, that you can view the agreement itself as a sale to the user who, at the end of the term, sells the car to a third party and retains the sale's proceeds.

Senator PACKWOOD. So you are saying it bears no hallmarks of a lease at all. It is a conditional sale from the time for a fixed period. You sell the car at the end of the fixed time—you being, in this case, what I call the lessee—and whatever the proceeds are determines what your liability is going to be to the lessor.

Ms. LEVINSON. That is right. In a conditional sale, the title rests in the sellor until the condition has been met, that is, all payments have been made. But we would still, for tax purposes, say that the user of the car, the customer, is the owner of the car throughout the term of the agreement.

If the agreement is characterized as a conditional sale, the user of the car, as we have just discussed, would be entitled to take the investment credit and ACRS deductions. If it is leased, then the dealer or the lessor takes those benefits.

In 1979, the IRS issued a technical advice memorandum stating that the agreement was a conditional sale, and that has been our litigating position. The *Swift Dodge* case in the ninth circuit so held. This issue was also not new to Congress. TEFRA, section 210, provided that terminal rental adjustment clauses were to be ignored in determining whether the agreement was a lease or a sale until Treasury regulations provided otherwise.

We proposed a regulation on November 23, 1982, stating that terminal rental adjustment clauses would make an agreement a conditional sale. A public hearing was held on February 10, 1983. We have not yet published a final regulation.

The bill at hand, S. 1161, would guarantee lease treatment to agreements containing terminal rental adjustment clauses. It would also extend lease treatment to vehicles used for personal use, which goes beyond the TEFRA provision, which had limited lease treatment to vehicles used in the trade or business of the lessee.

As I stated before, we oppose S. 1161. The effect of a terminal rental adjustment clause is that of a safe harbor lease, that is, the lessor is insulated from risk and, for tax purposes, is not considered to be the owner of the vehicle. If the lessor is then able to take tax benefits, we have effectively divorced the tax benefits from the ownership of the vehicle, and that is, in fact, what safe harbor leasing did.

As you know, Senator Packwood, we supported safe harbor leasing. However, last year in TEFRA, Congress repealed safe harbor leasing and substituted in its place finance leasing. We think that as a matter of equity the motor vehicle leasing industry should comply with the rules available to every other industry. I think that the transitional rules for the repeal of safe harbor leasing indicate that safe harbor leasing was needed and used by man industries, including the aircraft industry, the automobile manufacturing industry, the steel industry. To then allow the motor vehicle leasing industry what is in essence safe harbor leasing, and to force all of these other industries onto finance leases seems to us unfair.

Let me touch briefly on the arguments made by the industry on their behalf. They claim that the terminal rental adjustment clause lowers the cost of property to the customer. This is not true if both the user and the dealer are taxable; that is, if they are both taxable, the user could just as easily have purchased the property and used the tax benefits. When you add the risk that the customer takes at the end of the lease when it sells to a third party, and add the loss that he may sustain on the car to the rental payments under the TRAC leave, those payments, if both parties are taxable, should approximate a closed end agreement, that is, a true lease.

The only condition under which it might lower the cost of the property is if one of the parties cannot use the tax benefits. That is the classic safe harbor leasing transferability issue. And in that case, again, the leasing industry should be forced to comply with the rules available for everyone else.

Second, the industry claims that the service has not been whipsawed and that these agreements are not entered into for tax avoidance. As far as whipsawed, no one has significant evidence as to whether it is occurring or not, neither we nor they. Certainly with the state of the law the way it is now, there is ample opportunity for the IRS to be whipsawed.

In addition, as to tax avoidance, depending upon the relative tax positions of the user and the dealer, there can be tax avoidance. As soon as the transaction becomes a transferability transaction, there is tax avoidance because the benefits are being taken by the party who is in the best position to use them.

We admit that revenue estimates on this provision are slight, but we do not think that this issue should be decided on the basis of revenue. It is a slippery slope; there is no reason that we can see to justify singling out the motor vehicle industry for what is, in essence, safe harbor leasing treatment, and we do not think that there is any reason that other industries should not be able to use terminal rental adjustment clauses if the motor vehicle industry could use them.

Senator **Packwood**. In other words, you were saying that it would be just as easy to do this in the lease of machinery, for whatever purpose.

Ms. **Levinson**. Yes.

Senator **Packwood**. And, as you would call it, the purchaser would be bearing the risk, or, as I call it, the lessee would be bearing the risk, and you could do it in an industry.

Ms. **Levinson**. That is correct. That is what happened in safe harbor leasing.

There is one other aspect to S. 1161 with which we object. S. 1161 extends lease treatment to leases in which the property is being used by the customer for personal use. The subsidies for ACRS and the credit have always been allowed for business property, not for personal use property. The industry argues that if the agreement is characterized as a sale, the user would be entitled to an interest deduction, and that the provision would be tax neutral. This is beside the point. ACRS and the investment credit were not intended for personal use property. Even under safe harbor leasing, we insisted that the property be used in a trade or business of the user.

I will now turn to S. 562, which deals with the excess business holdings penalties on private foundations. Under current law, private foundations cannot own more than a certain percentage of stock in a business. If a foundation acquires stock in excess of the permissible percentages, by gift of bequest, the foundation has 5 years to divest itself of the stock before it incurs penalties. S. 562 would grant the IRS the discretion to extend the time period within which a foundation could divest itself of stock. The IRS would have the authority to take into account the following factors: That the foundation had took reasonable steps to dispose of the stock within the 5 years; that the foundation could reasonably be expected to divest itself of the stock in an extension period; and other factors, such as the relative size of the foundation's holdings; whether there has been litigation against the foundation; and whether there are Government regulations preventing or restricting the divestiture.

We understand that this bill has been introduced to help the John D. and Catherine T. MacArthur Foundation. That foundation, in 1978, received a bequest of $700 million, consisting of an insurance company and large real estate holdings. We believe that the MacArthur Foundation is a sympathetic case because of the size and complexity of its business holdings. The real estate and the health and accident insurance businesses that it runs are structurally complex, intertwined and of immense size. Because of this, we think that the bequest itself was outside the scope of the kinds of bequests Congress was contemplating in 1979 when it thought that 5 years was sufficient for a foundation to divest itself of business holdings. However, we think that the provision, as drafted, grants us too much authority; that is, that if we were to follow the bill, the IRS would end up rewriting the statute, based on the criteria it used for granting extensions. What we would propose is a narrower bill. We would propose that we could only grant one 5-year extension, not unlimited extensions. We would also propose more objective criteria for granting the extension, and make them prerequisites to obtaining one.

The first criteria would be that the foundation has shown a diligent effort to dispose of its stock. The second, that it is not possible for the foundation to dispose of the stock, except at a substantial loss, because either the foundation's holdings were unusually large and complex; there were restrictive statutes or regulations preventing the divestiture, or the foundation was under a court order that restricted divestiture for more than 2 years out of the 5-year period.

Third, we would require a realistic plan to dispose of the stock within the extension period and the consent of any State's attorney general who would be involved with the foundation. All of this is an effort so that the IRS would not be in the position of second guessing foundation managers as to how they could have divested and what deal they could have made. We are trying to reach some more objective criteria that would take us out of the business of running foundations. At the same time, we do not think that if the economic conditions are generally depressed, that the market, as a whole, is depressed, a foundation should be granted an extension. Any foundation manager has to work within the kind of market he finds himself.

One final word about S. 562. It would state that the stockholdings for the extension would relate to the holdings of the foundation immediately prior to the grant of extension. We are working on Code section 4943 regulations that would have rules regarding constructive ownership and the status of stock received in reorganizations. We request that these be left to regulations. We have put a lot of time and effort into the regulations, and we do not think it is appropriate at this time for statutory rules that would be different than the general rules under section 4943. For these reasons, we oppose S. 562 as written, but we would be more than happy to work with your committee in reworking it.

I would be happy to answer any questions that you have.

Senator Packwood. Ms. Levinson, I don't have any questions. I understand in this case Treasury's position very clearly and I understand why your position on both the bills is as it is. I don't know where I am going to come out on a least one of these bills, but I think we will be able to work something out with the Treasury, and I wish you good luck on your further ventures.

Ms. Levinson. Thank you very much.

Senator Packwood. Thank you for coming up.

I see Senator Dixon here, and I believe, Alan, you want to introduce somebody for our next panel, don't you?

Senator Dixon. Yes, sir.

Senator Packwood. Let's take the panel first on S. 862. It is a panel. You go first; you introduce who you are going to introduce. We have a panel of Dr. John Corbally; James Joseph; Eugene Rossides; and Norman Sugarman. If those gentlemen will come up and take their seats at the table, I will recognize Senator Dixon.

STATEMENT OF HON. ALAN DIXON, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator Dixon. Thank you, Mr. Chairman. I understand that my distinguished senior colleague, Senator Charles Percy, has already placed his statement in the record.

Senator Packwood. I have placed his statement in the record. I asked him if he wanted me to hold this hearing on a day when he could be here or whether he would rather have it done quickly and soon, and he chose the latter even though he could not be here.

Senator Dixon. Very good. Thank you, Mr. Chairman, and members of the committee. I am pleased to introduce to you, Mr. Chairman, this morning the president of the John D. and Catherine T. MacArthur Foundation, my good friend, Mr. John E. Corbally. The MacArthur Foundation has authorized expenditures of more than $128 million over the past 5 years for charitable, education, scientific, cultural, literary and environmental causes to recipients throughout the United States. To make what is a long and very distinguished story much too short, the MacArthur Foundation is providing a vital, indeed an irreplaceable service, to America. As Mr. Corbally's statement indicates, however, and a statement submitted for the record by the distinguished attorney general of my State, Mr. Neil Hartigan, the MacArthur Foundation faces immense problems in attempting to continue its good work unless it gets some relief from the requirement which will compel it to divest itself of its holdings of Bankers Life and Casualty Co. by November 30 of this year.

The foundation is attempting to comply with the Internal Revenue Code's 5-year divestiture requirement, but Bankers is worth over $2.2 billion, and it has not been possible as yet to find a buyer for all of its assets. The foundation, therefore, faces a Hobson's choice: either sell Bankers at a fire sale price to meet the time deadline, or face the punitive excise tax imposed by section 4943 of the Internal Revenue Code. Either option badly hurts the foundation's ability to continue with outstanding charitable activities.

I want to thank the subcommittee for scheduling this hearing on the legislation that my senior colleague from Illinois, Senator Percy, and I have introduced to solve this problem. This bill authorizes the Secretary of the Treasury to grant an extension of the 5-year divestiture period if he makes certain findings. The two most important are that the foundation had attempted in good faith to sell its business holdings during the initial 5-year period, and that orderly disposition of the holdings could not be reasonably expected to occur before time ran out.

I commend Mr. Corbally's statement to the committee, Mr. Chairman, along with the excellent statement of attorney general Hartigan, and, of course, that of my colleague, Senator Percy. I urge you to act as rapidly as you can on this issue because time is running out.

And, Mr. Chairman, if I may say at this time, in addition to what I have said on the record, I would like to make two points. The first is that last year—and I am embarrassed to say I cannot recall whether it was on that $99 billion tax bill or on the debt limit question—but last year my colleague, Senator Percy, and I had an amendment before the Senate, and we met with Treasury—and the chairman of this committee and the ranking member signed off, as did the Secretary of the Treasury and others—on a compromise that essentially was a 2-year extension at that time. Unfortunately, and all that transpired at that time, that particular accommodation did not survive. But I think that it is worthy of note that Treasury, on another occasion last year, found this to be a worthy case, and I would suggest to the Chair that it is. And I would also like to close by saying that not only is Dr. Corbally the chairman of this foundation and my good friend, Mr. Chairman, but he is also a distinguished former president of my alma mater, the great University of Illinois. And I know that you will give him very tender treatment, having that in mind. [Laughter.]

Senator Packwood. Tender wasn't the word I was going to use. [Laughter.]

What happened last time, we had half a dozen foundations.

Senator Dixon. That is exactly what happened.

Senator Packwood. All of them though were not in exactly the same shape. It was not that they all wanted exactly the same kind of relief.

Senator Dixon. No.

Senator Packwood. And we took care of a good many of them. But when we went to conference the House would not accept any of them.

Senator Dixon. My recollection, Mr. Chairman, and it may be a little hazy, is that there were at least six, and that several of the Senators wanted a complete exemption.

Senator Packwood. That is correct.

Senator DIXON. We would have satisfied ourselves with considerably less than that. And so I would again suggest that our position and the position of this foundation is a very reasonable one. And we come before this committee and our friends in the Congress suggesting that it is an equitable case.

Senator PACKWOOD. Alan, thank you. I will place Senator Percy's statement in the record with yours. And we will start with the witnesses. Again, if you would summarize your statements, I would greatly appreciate it. And we will start with Dr. Corbally.

[The prepared written statements of Senators Dixon and Percy follow:]

STATEMENT OF SENATOR ALAN J. DIXON

Mr. Chairman and members of the committee, I am pleased to introduce to you this morning the president of the John D. and Catherine T. MacArthur Foundation, Mr. John E. Corbally.

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As Mr. Corbally's statement indicates, however, and a statement submitted for the record by the distinguished attorney-general of Illinois, Neil Hartigan, the MacArthur Foundation faces immense problems in attempting to continue its good work unless it gets some relief from the requirement which will compel it to divest itself of its holdings of Bankers Life and Casualty Co. by November 30, 1983.

The foundation is attempting to comply with the Internal Revenue Code's 5-year divestiture requirement, but Bankers is worth over $2.2 billion, and it has not been possible as yet to find a buyer for all of its assets. The foundation, therefore, faces a Hobson's choice: either sell Bankers at a fire sale price to meet the time deadline, or face the punitive excise tax imposed by section 4943 of the Internal Revenue Code, either option badly hurts the foundation's ability to continue its outstanding charitable activities.

I want to thank the subcommittee for scheduling this hearing on the legislation that my senior colleague from Illinois, Senator Percy, and I have introduced to solve this terrible problem.

This bill authorizes the Secretary of the Treasury to grant an extension of the 5-year divestiture period if he makes certain findings. The two most important are that the foundation had attempted in good faith to sell its business holdings during the initial 5-year period, and that orderly disposition of the holdings could not be reasonably expected to occur before time ran out.

I commend Mr. Corbally's statement to the committee, along with the excellent statement of Attorney-General Hartigan. I urge you to act as rapidly as you can on this issue because time is running out.

STATEMENT OF THE HONORABLE CHARLES H. PERCY

Dear Mr. Chairman: On February 23, 1983, Senator Dixon and I introduced in the Senate of the United States a bill, S. 562, to authorize the Secretary of the Treasury to grant extensions of the five year period within which private foundations must dispose of excess business holdings. Under present law, the period cannot be extended under any circumstances. We believe our proposal is a needed grant of authority to the Secretary to extend the period in those unusual circumstances in which a foundation, despite its good faith and diligent efforts, has been unable to dispose of its business interests.

PRESENT LAW

The Tax Reform Act of 1969 imposed an excise tax on the excess business holdings of a private foundation. Basically, the combined ownership of a business by a private foundation and all disqualified persons cannot exceed 20 percent of the voting stock of the business (35 percent if other persons have effective control of the business).

The Act provided that if a private foundation received by gift or bequest stock of an operating business in excess of the permissible amounts, the foundation had a five year grace period from the date of receipt in which to reduce its holdings to permissible levels.

The enactment of this provision was clearly a result of Congress' concern that in many instances family-run private foundations were a source of tax abuse. Congressional studies showed that in many cases families used private foundations' exempt status to obtain an unfair competitive advantage over other businesses and indicated the foundations' assets were used primarily for the private benefit of family members and not for the public good. This was especially true where family owned and managed businesses were placed into a foundation whose directors were the same family members who had managed the business prior to the creation of the foundation. Congress concluded that the solution to this problem was to require private foundations to relinquish control of active businesses. In order to allow private foundations which received business holdings by gift or bequest sufficient time to sell their holdings in an orderly manner, Congress allowed five years' grace before the excise tax would be imposed. Congress expected that five years would be sufficient time to allow private foundations to dispose of their business interests.

REASONS FOR CHANGE

In the vast majority of cases, the five year divestiture period has proved sufficient to allow private foundations to sell or otherwise dispose of their business interests. However, in highly unusual situations, the five year divestiture period has proved to be inadequate. A case in point is the John D. and Catherine T. MacArthur Foundation (the "Foundation") which presently has until November 30, 1983 to effect a divestiture. Due to a number of unique circumstances, the Foundation has been unable to divest itself of its holdings, which consist of 100 percent of the stock of Bankers Life and Casualty Company of Chicago, Illinois ("Bankers").

The most obvious unique feature of the Foundation is the huge size of the Foundation's holdings. At the close of 1982, Bankers had assets with a gross value of more than $2.2 billion and a net asset value which may exceed $875 million. The size of these assets alone distinguishes the Foundation from most private foundations affected by the five year divestiture rule of Section 4943.

Another problem of divestiture has been the fact that sale had to be accomplished during a period (1978-1983) in which the United States experienced escalating inflation, record interest rates and marginal economic growth. The depressed state of the U.S. and world economies has inhibited divestiture.

In addition to the size of the Foundation's holdings and the state of the economy, other factors have prevented sale. One is the diversity of Bankers' assets. Bankers' holdings consist of a large operating insurance business (primarily in the accident and health field) and significant real estate holdings located throughout the United States.

Unlike the relatively small family-run businesses which were the focus of the 1969 Act, Bankers is a huge conglomerate which has no MacArthur family members associated with it in any capacity. As a result, the abuses at which the Act was directed simply have not occurred.

The Foundation will probably be forced to sell Bankers' shares at distress prices, if a sale must take place by November 30, 1983. A distress sale would mean that the Foundation would be left with sale proceeds which do not reflect the actual value of Bankers' assets. A reduced endowment base means that smaller grants will be made to charitable organizations than would be possible if the sale had produced proceeds reflecting the true value of the Foundation's assets. Such a result was not the objective of Section 4943.

In a situation such as the Foundation's case, a foundation should not be forced to choose between paying a heavy excise tax or entering into a distress sale. Rather, the circumstances in which the Foundation finds itself represent a classic case in which an extension of time to allow orderly sale should be allowed. Such an extension is particularly appropriate in light of President Reagan's call for increased voluntarism and private sector initiative in philanthropy. The MacArthur Foundation has made grants of over $128,000,000 during its five years of existence. These grants have been made to recipients throughout the U.S. for a wide range of educational, scientific, cultural, literary and environmental causes and include the unique and creative Prize Fellows Program and the preservation of Harpers' Magazine, examples of activities of great merit not appropriately undertaken by the federal government. These grants in part relieve the federal government from the need to make expenditures of public funds in these areas.

I believe one objective of legislation governing charities should be to encourage private citizens to assume more of the financial responsibility for solving societal problems and social welfare programs. The Foundation has demonstrated a creativity and breadth of philanthropic activity which cannot, and should not, be assumed by the federal government.

A full review of the grants of the Foundation provides many more examples of the Foundation's support of scientific research, education, human rights and social welfare which in part relieve the federal government from the need to fund these activities. An extension of time will permit the Foundation to maximize its grantmaking abilities by ensuring it sufficient time to make an orderly sale of its holdings.

GENERAL EXPLANATION OF LEGISLATION

S. 562 provides a simple and flexible means by which extensions of the five year divestiture period can be granted to qualifying private foundations.

Basically, the Secretary of the Treasury would be empowered to grant one or more extensions to a private foundation subject to the five year divestiture rule, if the Secretary determined, in the Secretary's sole discretion, that an extension was warranted. The Secretary would examine a set of fair and objective criteria, which would include: the efforts by the private foundation to dispose of its business interests within the five year period; a finding by the Secretary that orderly disposition could not be completed within the five year period; and other relevant data, including the size of the foundation's holdings as compared with other enterprises engaged in a comparable trade or business, possible adverse economic impact if a distress sale is forced upon the foundation, litigation pending against the foundation which may impede divestiture or regulations prescribed by a governmental body which also may impede divestiture, and the recommendation of the Attorney General of the state of incorporation of the private foundation (or other state official charged with supervision of private foundations) that an extension be granted.

In the case of the Foundation a complete exemption from divestiture is neither appropriate nor sought. S. 562 does not provide any exemption from the divestiture requirements, nor does it provide any automatic extension of any set number of years.

It is a matter of common knowledge that the United States economy in recent years has taken on a very different complexion than it had fourteen years ago when the excess business holdings provisions of section 4943 were enacted. The inflation and recessionary economy of the recent past have made large scale divestitures very difficult. S. 562 will provide a fair and flexible means of dealing with private foundations which, through no fault of their own and due in part to the vicissitudes of recent business cycles, have been unable to dispose of their holdings.

There is no good reason for the federal tax system to force distress sales on those private foundations which have exhausted every available avenue to dispose of their business interests within the five year period. A distress sale does not result in any additional funds passing into the federal coffers. The American public is obviously injured by the reduced endowment base available to the foundation.

We believe S. 562 provides a fair and workable approach to the problem of foundations which, because of unusual circumstances, need limited extensions of time in which to dispose of their business interests.

We welcome any comments of the Treasury Department and have worked closely with the Treasury Department in formulating this legislation. We hope to continue to work with the Treasury Department in regard to any modifications which they believe advisable.

Our tax system is premised on the belief that the private sector should work together with the public sector in shouldering the financial responsibility for charitable giving. This system is frustrated by forced depletion of private sector assets, particularly when such forced depletion serves no revenue raising purpose. S. 562 will encourage private sector giving, but within the statutory objectives of the 1969 Act. I urge the Finance Committee to act quickly on this important legislation so that the Senate can consider it well before the MacArthur Foundation is faced with divestiture at the end of November this year.

STATEMENT OF DR. JOHN E. CORBALLY, PRESIDENT, JOHN D. AND CATHERINE T. MacARTHUR FOUNDATION, CHICAGO, ILL.

Dr. Corbally. Mr. Chairman, both Senator Dixon and the representative of the Treasury have made our case I think very well. I would want to say, first, that I am somewhat surprised, but not dismayed, by the testimony from Treasury because we have, at the time this bill was written, discussed it with other representatives and have asked for suggestions for change, and this was where we received suggestions. I don't believe that the suggestions made represent insurmountable obstacles to the attainment of our objective, which is, simply stated, to get an extension of time for the divestiture of this very complex business rather than to be exempted from what we consider to be a very legitimate requirement related to excess business holdings.

Senator **Packwood**. Doctor, let me ask you this. You heard Treasury say that foundations ought to have to sink or swim with the rest of the community if you happen to be dealing in a down market. Is your problem simply that you cannot dispose of them for an adequate price because the entire market is down, or would you say that you have a unique circumstance different than everybody else involved in the disposition of property?

Dr. **Corbally**. I would argue that the economic situation has been a factor but is not the primary factor, and that the complexity of the bequest to the MacArthur Foundation and such factors as the fact that it had always been privately owned and, therefore, it took us about 2½ years to determine, with a great deal of outside help, what the estimated value of this complex business was. So it is much more than the economic setting.

I think I would just very briefly comment that we have over this 5-year period contacted and worked closely with approximately 130 potential buyers of all or a part of Bankers Life & Casualty Co. Our written statement describes Bankers Life, which is a very complex insurance, real estate and many other miscellaneous holdings corporation. We have worked with some prospective buyers for as long as 1 year to 1½ years. I spent most of yesterday with a committee of the board of the foundation reviewing at least three current negotiations that are now underway. So we are not simply sitting and waiting. We are working hard to attempt to solve this problem, and have introduced this legislation to attempt to deal with special case. I would be glad to respond to questions if there are any.

Senator **Packwood**. I think, Doctor, I will take the entire panel and then see if I have questions.

Dr. **Corbally**. Thank you.

[The prepared written statements of Dr. Corbally and Neil F. Hartigan follow:]

SUBCOMMITTEE OF TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

HEARINGS WITH RESPECT TO S. 562
JUNE 7, 1983

STATEMENT OF DR. JOHN E. CORBALLY
PRESIDENT OF JOHN D. AND CATHERINE T. MACARTHUR FOUNDATION

I am pleased to be here today on behalf of the John D. and Catherine T. MacArthur Foundation to testify regarding S. 562. I would like to discuss with you the immense problem faced by the MacArthur Foundation and possibly other foundations in meeting the five year divestiture requirement imposed upon foundations for certain business interests received by gift or bequest.

The MacArthur Foundation owns 100% of Bankers Life and Casualty Company which is an insurance company. Besides its insurance assets, Bankers and its subsidiaries own substantial real estate assets. The assets of Bankers exceed $2.2 billion in value. At this point, the Foundation must either sell Bankers' businesses by November 30, 1983, or face the onerous punitive excise tax imposed by Section 4943.

Since receipt of Bankers' shares on December 1, 1978, the Foundation has used all its efforts to diligently comply with the divestiture requirements. It has hired two internationally known independent investment advisors to advise it with respect to divestiture alternatives, which included consideration of a public offering. The Foundation and its advisors have had over 300 inquiries from both U.S. and foreign enterprises (including certain of the "Fortune 500" corporations) and have held active discussions with over 100 potential purchasers, some in great depth in very extensive discussions. However, no purchaser has been found to date.

The congressional hearings and legislative history of the excess business holdings provisions indicate that a five year period should normally be sufficient. Our review of foundations created within the last five years clearly indicates that five years would be adequate under normal circumstances. However, due to extraordinary circumstances beyond its control, the MacArthur Foundation is not able to comply with the five year period.

The reason for the difficulty in achieving the five year divestiture is primarily the size of Bankers' operations. If Bankers could be sold as one entity, the transaction would rank in the top 20 of all corporate transactions to date. Excluding oil companies, the transaction would rank in the top 10.

The size of Bankers' insurance operations is significant in itself. Bankers is primarily engaged in the accident and health insurance field. If Bankers' insurance operations are disposed of, it will be the largest sale of accident and health insurance to date and will exceed by two times any previous sales of blocks of insurance business. In our review of various foundations, the sale of the MacArthur Foundation's holdings has in fact been a unique situation in terms of its size. Every foundation created during the 5 year period from 1975-1979 was less than one-sixth of the size of the MacArthur Foundation. Thus, simply the magnitude of the size of the proposed sale is an unusual burden.

This attempted divestiture took place during a time (1978-1983) when we experienced a recession, extraordinarily high inflation, and extraordinarily high interest rates. Thus, while the Foundation has made all possible attempts to comply, its size and prevailing economic conditions have precluded divestiture.

There have been other factors which frustrated divestiture. Bankers' real estate holdings are diverse and scattered throughout the United States. Some of the properties are residential or commercial; other properties are vacant or recreational, such as golf courses, country clubs and hotels. Finding a buyer interested in acquiring these unrelated and geographically dispersed properties has proved impossible to date.

Another problem relates to Bankers' insurance operations. Seventy percent of Bankers' insurance operations are accident and health insurance. Insurance business of this type is under intense pressure because of skyrocketing medical costs and the difficulty of passing such costs on through increased premiums. Also, a substantial portion of Bankers' policies are Medicare reimbursement policies. As the federal government shifts more of the costs of Medicare to the private sector, the profitability of medical insurance declines. In addition to these problems, the insurance industry is heavily regulated. These factors diminish the attractiveness of Bankers' insurance operations.

When legislation was adopted in 1969, various foundations received varying periods of time of 10, 15, or 20 years in which to make divestiture. All but three of the fifty largest foundations were created prior to 1969 and had those substantial periods of time within which to divest. The MacArthur Foundation ranks within the top five largest foundations and is the only foundation of this magnitude with a five year divestiture period. The drafters of the 1969 legislation obviously could not have foreseen that the five year divestiture period would result in a distress sale such as the MacArthur Foundation faces, since they could not have predicted the difficulties caused by such a unique situation.

The statute as presently drafted provides no administrative ability to grant an extension for extraordinary circumstances such as those facing the MacArthur Foundation. Legislative relief in the form of S.562 introduced by Senators Percy and Dixon addresses this administrative incapacity.

The MacArthur Foundation is not asking for relief in the form of a complete exemption nor an automatic extension for a set number of years. Rather the Foundation recommends that the granting of an extension and the length of the extension be in the sole discretion of the Secretary of the Treasury. The suggested legislation provides that a foundation facing a distress sale could submit a request to the Secretary for an extension. The burden would be on the foundation to satisfy the Secretary that an extension is warranted. The legislation sets forth various types of factors which the Secretary would consider, which would include evidence of the foundation's good faith efforts to dispose of its holdings, findings by the Secretary that the divestiture could not be completed within the required period, evidence of the size of the foundation's holdings as well as other enterprises engaged in a comparable trade or business, adverse economic impact caused by a forced divestiture, litigation pending against the foundation and regulations prescribed by a governmental body, either of which may inhibit or prevent disposition, and finally a recommendation by the Attorney General of the state where the foundation is incorporated that an extension be granted. The MacArthur Foundation's situation meets these objective criteria for qualification for an extension and the Illinois Attorney General has recommended that an extension be granted to the MacArthur Foundation.

These criteria represent objective guidelines which would provide a fair test to any foundation seeking an extension of a divestiture deadline. The objective criteria would remove to a certain extent the administrative burden imposed on the Secretary in granting an extension. Similar criteria already exist in the federal regulations for extensions of the second level tax imposed by the excess business holdings rules. The proposed legislation would merely authorize an extension for the first level tax under a set of criteria already applicable to the second level tax.

Representatives of the MacArthur Foundation have worked closely with the officials of the Treasury Department in preparing the draft legislation and appreciated the assistance of the Treasury. The Foundation is open to other suggestions or changes which would allow flexibility in this area.

If the Foundation must sell before December 1, 1983, it will be a distress sale which would mean that the Foundation will not realize a fair price for its holdings. A distress sale will reduce the Foundation's asset base, thereby reducing the Foundation's ability to make charitable distributions. The charitable donees of the Foundation will receive fewer benefits. No federal tax revenues will result from a distress sale. The only person who will benefit from a distress sale will be the purchaser of Bankers who will acquire Bankers' assets at a below market price.

This contraction in the Foundation's ability to support worthy charitable causes would take place at a time when the need for private sector charitable initiative is crucial in light of reduced federal spending. The current administration is on record many times as requesting the private sector to step in to bear a greater share of responsibility for philanthropy. The Foundation hopes to continue its programs which have resulted in grants of $128.0 million during its short five year period of existence. Allowing this additional time will allow the Foundation to realize a reasonable price for its holdings. The type of legislation that the Foundation supports would insure this result and allow the Foundation to move forward to fulfill its charitable obligations.

NEIL F. HARTIGAN
ATTORNEY GENERAL
STATE OF ILLINOIS

(312) 793-7086

June 3, 1983

Subcommittee of Taxation and Debt Management
Senate Finance Committee
Room SD-221
Dirksen Senate Office Building
Washington, D.C. 20510

Re: S. 562

Gentlemen:

The Attorney General of the State of Illinois is responsible for administration and supervision of charitable foundations located in Illinois. The John D. and Catherine T. MacArthur Foundation (the "Foundation") is an Illinois not-for-profit corporation and is subject to review and supervision of the office of the Illinois Attorney General.

The statutes of the State of Illinois specifically incorporate many of the federal private foundation rules, including the prohibition against private foundations' owning active businesses as provided for in Section 4943(c)(6) of the Internal Revenue Code. I am in agreement with the intent and purpose of Section 4943. The continued control of family businesses by family members of the donor has the potential of diverting foundations from their legitimate charitable duties. In my opinion, S. 562 is consistent with the Congressional intent underlying Section 4943(c)(6) for it obligates a foundation to demonstrate to the satisfaction of the Secretary of the Treasury its good faith attempts to dispose of the prescribed ownership in active businesses. The monitoring function which the Secretary of the Treasury is thus enabled to perform insures compliance with Section 4943(c)(6) while providing flexibility for conditions which the foundation cannot control. I therefore support enactment of S.562.

A study of the role of the Foundation supports the need for flexibility in applying the legislative mandate.

The Board of Directors of the Foundation presently consists of eleven members, all of whom are individuals of national eminence and stature. They include my colleague, John E. Corbally, former president of the University of Illinois; Gaylord Freeman, former chairman of the board of the First National Bank of Chicago; Murray Gell-Mann, a Nobel Laureate; Edward H. Levi, former Attorney General of the United States; Jonas Salk, developer of the polio vaccine which bears his name; J. Roderick MacArthur, son of John D. MacArthur; William T. Kirby, General Counsel of the Foundation; and Jerome B.Wiesner, former president of the Massachusetts Institute of Technology. Members of the family of John MacArthur do not control the activities of the MacArthur Foundation as

J. Roderick MacArthur is only one member of the eleven active Board Members.

The Foundation Board as presently constituted was elected partly in recognition that the requirement of divestiture imposed on the Foundation would require the participation and contribution of people of unquestionable integrity and skill. The hope was that this group of exceptionally talented individuals would be able to marshall the forces necessary to dispose of the Foundation's holdings in Bankers Life and Casualty Company ("Bankers"), an Illinois insurance company, within the divestiture period for a price which would reflect the true market value of those shares. I am familiar with the efforts made by the directors to sell those shares. Their efforts have continued on an uninterrupted basis during the entire five year period and have involved contacts with hundreds of potential purchasers throughout the United States and abroad. However, despite their efforts, no purchaser has been found.

Data and testimony have been provided as to the inherent difficulties in a sale of an enterprise of the size and complexity of Bankers. At this point, it seems virtually certain that no purchaser will emerge in time to allow the divestiture to be completed by the November 30, 1983, deadline.

Obviously, a distress sale will mean that the assets of the Foundation will be liquidated at a price substantially below the value that they would generate if the sale could be made in the normal course of business. Inevitably, the Foundation's endowment base will be eroded. This erosion will mean that the Foundation will be unable to continue its program of charitable giving on the scale and with the creativity and diversity which the Foundation has demonstrated in the five years of its existence. I would like to focus attention on the grave detriment to the citizens of the State of Illinois and the American public in general if the assets of the Foundation are disposed of in a distress sale.

Because of the close connection of John D. MacArthur to Chicago and to Illinois, the Foundation through its Special Grants Program has made extensive grants in Illinois. In 1980 and 1981 alone, the Foundation grants to Illinois charitable organizations totalled over $12 million, including grants to many local community groups which would not normally have access to funds to carry out their charitable purposes.

The Foundation has also supported organizations concerned with urban problems and human needs, including particularly the needs of disadvantaged and minority youth, high school dropouts and unwed teenage mothers. I regard grants of this nature as crucial to the revitalization of the core city and to aid minority groups and urban poor.

The Foundation has undertaken programs and activities which would not be appropriate for federal or state governments to pursue. An example would be the grant to Harper's Magazine Foundation, which is devoted to preserving the 130 year old Harpers Magazine, a literary periodical which has throughout its history served as an important forum for literary works, particularly by new authors, and advancement of intellectual thought.

The Foundation has been characterized by initiative and creativity in responding to public needs. Rather than merely passively responding to social problems or demands for funding, the Foundation has reached out in unusual and creative ways. The Prize Fellows Program, which has received so much favorable publicity for its grants to individuals of unusual creativity and productivity, is a case in point. The Health Program, which supports research into mental health, is a further example of the Foundation's resourcefulness, by attempting to fill a void in medical researech.

In an era of shrinking federal, state and local public funds available to devote to these problems, I consider it critical that the Foundation's financial ability to continue its activities not be diminished.

I believe legislation authorizing the Secretary of the Treasury to grant extensions if a foundation can demonstrate its need for additional time is approptiate and in the public interest. Based on my review of the facts and circumstances surrounding the Foundation and its divestiture history, enactment of S. 562 is warranted.

Respectfully submitted,

NEIL F. HARTIGAN
ATTORNEY GENERAL OF THE
STATE OF ILLINOIS

Senator PACKWOOD. Mr. Joseph.

STATEMENT OF JAMES JOSEPH, PRESIDENT, COUNCIL ON FOUNDATIONS, WASHINGTON, D.C.

Mr. JOSEPH. Mr. Chairman, I am pleased to appear before you in my capacity as president of the Council on Foundations. I might add that the Council on Foundations is located in Washington, D.C., rather than in Chicago as listed in the witness list.

Senator PACKWOOD. Thank you. We will have that correction made. I appreciate it.

Mr. JOSEPH. The council is a national organization of slightly less than 1,000 grant makers. The members of the council hold more than 50 percent of all foundation assets. I would simply like to make a few brief points, Mr. Chairman.

First of all, in its 1974 recommendations to the Commission on Private Philanthropy and Public Needs, the so-called Filer Commission, the Council on Foundations decided against recommending the repeal of the excess business holdings rules, except for the holdings which were acquired after 1969. In that case, the council urged that the law be changed to allow 10 years for divestiture instead of 5. That was in 1974. More recently, in its 1982 submission to the Impediments Committee of the President's Task Force on Private Sector Initiatives, the council reaffirmed its decision not to recommend repeal of the excess business holdings rules and urged that the 5-year rule be increased to 10 or 15 years.

Mr. Chairman, the circumstances facing the John D. and Catherine T. MacArthur Foundation in selling their excess holdings represent a classic example of the kind of problem the council has been concerned about and has spoken to since 1974. It is with this in mind then that the Council on Foundations, an organization of about 1,000 grant makers, supports Senate bill 562. We find its provisions to be entirely consistent with longstanding council policy. I am pleased, therefore, as president of the council to urge the speedy adoption of that bill.

Senator PACKWOOD. Mr. Joseph, thank you. I am familiar with the work of your foundation and have found it very excellent in the past.

[The prepared written statement of Mr. Joseph follows:]

STATEMENT OF JAMES A. JOSEPH, PRESIDENT, COUNCIL ON FOUNDATIONS

MR. CHAIRMAN, Members of the Subcommittee, my name is James A. Joseph, and I am President of the Council on Foundations. We appreciate very much the opportunity to testify before you concerning S. 562, a bill to authorize the Secretary of the Treasury to grant extensions of the 5-year period within which certain private foundations must dispose of excess business holdings as defined in Section 4943 of the Code.

Organized in 1949 to promote responsible and effective philanthropy, the Council today includes in its membership 610 private independent foundations, 160 community foundations, 110 corporate foundations, 40 corporate donors without foundations, and 20 public charities with substantial grantmaking programs. Council members hold over 50 percent of all foundation assets in the country.

COUNCIL'S POSITION ON EXCESS BUSINESS HOLDINGS

As part of the Tax Reform Act of 1969, Congress established a comprehensive set of legal restrictions closely regulating the conduct of private foundations. These restrictions included well-defined limitations on the percent of business ownership that could be maintained by a foundation. Taken in their full context, the reforms of 1969 have been supported by the Council on Foundations, including the provisions that prohibit excess business holdings.

More specifically, in its 1974 recommendations to the Commission on Private Philanthropy and Public Needs (the Filer Commission), the Council decided against recommendation of repeal of the excess business holdings rules, but stated:

"For foundations established after 1969 and for gifts of control stock received by other foundations after that time, the period allowed for divestiture is only five years. This can be the cause of severe difficulty and loss not only to a potential foundation but to others as well. Change in the law to permit a 10-year transition period on divestiture for post-1969 situations would reduce such problems ...Such change is therefore recommended."

More recently in 1982, two separate developments focused renewed interest in the rules against excess business holdings:

1) several individual foundations came before the Senate Finance Committee seeking special legislative relief, and

2) the President's Task Force on Private Sector Initiatives established a Committee on Impediments to identify legislative and regulatory problems facing the private sector.

Although the Council did not take a position on any of the special interest bills introduced in the last Congress, we followed their progress very closely.

However, in response to a request from Rep. Barber B. Conable, Jr. (R-NY), the Chairman of the Committee on Impediments, the Council did develop a list of 12 impediments affecting private foundations. With respect to the issue of excess business holdings, the Council reaffirmed its decision not to recommend repeal of the restrictions on foundation business holdings, and we restated our concern about the limited 5-year rule for divestiture of past-1969 holdings. Specifically we stated: "A foundation subject to this relatively short 5-year deadline is at a substantial disadvantage in negotiating with prospective purchasers who may prolong negotiations in the hope of obtaining a better deal as the deadline pressures on the foundation increase. Faced with the prospect of such a forced sale, many potential donors simply decide against making a gift of closely held stock to a foundation. This threat to the future grant capability of foundations could be largely eliminated, without undermining the effectiveness of the basic business holdings rules, by extending the divestiture period for excess holdings acquired by gift or bequest to 10 or 15 years."

Since developing our input to the Committee on Impediments, our position with respect to business holdings has not changed.

THE COUNCIL SUPPORTS S. 562

In our view the circumstances facing The John D. and Catherine T. MacArthur Foundation in their efforts to comply with Section 4943 represent a classic example of precisely the kind of problem that has concerned our members, and it illustrates full well the necessity for legislative action. While the 5-year rule may be sufficient in some cases, clearly — in certain circumstances -- requiring divestiture of post-1969 holdings in no more than 5 years is not in the best interests of promoting charitable activity on the part of private foundations.

Neither the Council nor the MacArthur Foundation is seeking any fundamental change in the rules limiting business holdings. We are only suggesting that, for those obtaining such holdings after 1969, the time required to comply can be counterproductive. Under present law there simply is no flexibility, no matter how compelling the case. In approving the 5-year rule, Congress simply did not take into consideration the time-consuming problems that can arise. A depressed economy, state law conflicts, and the difficulties of selling a major holding in a narrow market are just some of the problems that can be encountered.

I would emphasize to this Subcommittee, Mr. Chairman, that this bill does not advocate time extensions to any foundation that wants one. Clearly the burden of proof will be on the foundation to prove its case, to show that it has made an extensive good faith effort to divest in the time permitted.

In summary, Mr. Chairman, we have examined the detailed provisions of S. 562, and we find it to be entirely consistent with long-standing Council policy. Without some legislative relief, we will continue to see foundations faced with a short deadline and forced to make the difficult choice of either selling a valuable asset dedicated to charitable purposes at a great loss, or failing to comply with the law. Neither of these options is desirable. By providing a limited but reasonable alternative choice, S. 562 offers a sensible escape from this dilemma. We urge its speedy adoption.

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Mr. Chairman, that concludes my statement. If the Council on Foundations can be of any further assistance to you with respect to this bill, or with respect to other legislation affecting private foundations, we will be glad to help.

Senator PACKWOOD. Mr. Rossides.

STATEMENT OF EUGENE T. ROSSIDES, ROGERS & WELLS, WASHINGTON, D.C., ON BEHALF OF THE CAFRITZ FOUNDATION

Mr. ROSSIDES. Thank you, Mr. Chairman. On behalf of the Cafritz Foundation, we want to say that we also support S. 562 to permit the orderly disposition of the holdings of the MacArthur Foundation and other possibly similar situation foundations. We would like to take this opportunity, Mr. Chairman, to bring to the attention of the committee another problem dealing with the Cafritz Foundation, and urge careful consideration by the committee of an amendment to correct an unexplained disparty and inconsistency in the transition rules, Mr. Chairman, for pre-1969 act foundation holdings.

Under the existing law, if a private foundation and disqualified persons own more than 75 percent of the stock of the business enterprise they were given 15 years, as you know, Mr. Chairman, to reduce their holdings to 50 percent; whereas, if the private foundation owned more than 95 percent of the stock, it was given 20 years to reduce its holdings to 50 percent.

The 20-year transition period was added in conference, presumably because Congress recognized that it would be difficult to reduce a holding as large as 95 percent to 50 percent within the 15-year period allowed for 75 percent holdings.

Mr. Chairman, we have found no explanation in the legislative history for the 20-year period. Presumably it was because of the recognition of the extra time needed. However, this disparity in treatment is inconsistent when you have a situation such as the Cafritz Foundation, where the stockholdings of the foundation and the disqualified persons equal 100 percent in this case, when, in 1964, the testator left these holdings to the foundation in a marital trust.

It impacts because it is very difficult for a foundation which shares with a disqualified person a 95 percent of stock interest to negotiate a sale. It is more difficult, Mr. Chairman, for them to negotiate a sale of the property than a foundation which exclusively owns 95 percent of the stock. And we would urge the committee to take a look at that, Mr. Chairman. We think that it is fully consistent with the 20-year rule. All we are asking is that we be treated in the same manner as a foundation which owns a 95-percent stock interest.

Briefly, it will correct the unexplained disparity and inconsistency. It is consistent with the 20-year transition period concept to permit the orderly disposition of preexisting holdings. It will alleviate a substantial hardship to the Cafritz Foundation created by an immediate forced sale. And the fact that the other owner is a trust makes it an added problem, Mr. Chairman, with their fiduciary responsibilities. It would have no revenue impact and would give rise to none of the abuses which the statute was intended to rectify. The Cafritz Foundation would be allowed to continue fully their fine work in the District. They are the largest private foundation in the Metropolitan Washington, D.C. area. They have a fine record of accomplishment. They have an advisory board of distinguished citizens which deals with their grants, Mr. Chairman. Our full statement is submitted for the record. Thank you, Mr. Chairman.

Senator **Packwood**. Thank you. I have to confess, although I was in Congress at the time, I cannot remember the reason for this. Probably it was unintentional, is my hunch, for this disparity you called to our intention.

Mr. **Rossides**. Right.

Senator **Packwood**. I don't think it was malicious; just unintentional.

Mr. **Rossides**. No, no. We really look on it merely as a technical amendment, Mr. Chairman.

Senator **Packwood**. Mr. Sugarman.

[The prepared written statement of Mr. Rossides follows:]

TESTIMONY OF EUGENE T. ROSSIDES
ON S.562 BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

June 7, 1983 Washington,D.C.

Mr. Chairman and Members of the Subcommittee, my name is Eugene T. Rossides. I am a partner in the law firm of Rogers & Wells and am here to testify on behalf of the Morris and Gwendolyn Cafritz Foundation, which is the largest private foundation serving the Washington Metropolitan Area.

S.562 authorizes the Secretary of the Treasury to grant extensions of the five-year period within which private foundations must dispose of excess business holdings acquired after enactment of the Tax Reform Act of 1969 in order to permit orderly disposition of such holdings. The Cafritz Foundation supports S.562 because it will alleviate the severe hardship which divestiture at this time will have on the MacArthur Foundation and possibly other private foundations similarly situated.

At the same time, Congress should also correct an unexplained disparity and inconsistency in the transition rules for pre-Act foundation holdings which will have a severe, unintended, and unwarranted impact on the Cafritz Foundation.

Under existing law if a private foundation and disqualified persons owned more than 75% of the stock of a business enterprise in 1969, they were given fifteen years to reduce their holdings to 50%, whereas if a private foundation owned more than 95% of the stock, it was given twenty years to reduce its holdings to 50%. The twenty-year transition period was added in conference presumably because Congress recognized that it would be difficult to reduce a holding as large as 95% to 50% within the fifteen-year period allowed for 75% holdings.

There is no explanation in the legislative history why holdings of the foundation and disqualified persons are aggregated for purposes of the 75% stock interest -- 15-year transition period but not for the 95% stock interest -- 20-year transition period. Moreover, this disparity in treatment is inconsistent with the underlying purpose of the twenty-year provision since it is more difficult to dispose of a large block of stock where the stock is not under the exclusive control of the private foundation but rather is shared with a disqualified person.

The disparity impacts the Cafritz Foundation because, while it and a marital trust (a disqualified person) received 100% of the stock of a company from a testator who died in 1964, under existing law their holdings cannot be aggregated so as to qualify for the 95% twenty-year transition period. The problem is compounded by the fact that the trust is subject to fiduciary restraints upon the sale of its stock.

Unless this disparity is corrected, the Cafritz Foundation will be required to sell -- probably at a very substantial loss -- most of its two-thirds stock interest in the Cafritz Company, a management company which efficiently manages and conserves the Foundation's widespread passive real estate holdings.

Attached is a memorandum which fully describes the severe problems the Cafritz Foundation faces and proposes a conforming amendment that will eliminate the disparity.

I would like briefly to emphasize the following points:

1. The proposed conforming amendment will correct an unexplained disparity and inconsistency in the transition rules for disposition of excess business holdings of a private foundation.

2. The proposed amendment is consistent with the purpose of the twenty-year transition period which is to permit orderly disposition of preexisting holdings of 95% or more of a stock.

3. The proposed amendment will alleviate the substantial hardship to the Cafritz Foundation which would be created by an immediate forced sale of substantially all of its stock in a company that effectively manages the Foundation's widespread passive real estate holdings.

4. The proposed amendment would have no revenue effect nor would it give rise to any of the abuses which the statute was intended to rectify. Rather, it will allow the largest private foundation serving the metropolitan Washington, D.C. area to continue to preserve and protect its passive investments and continue its substantial grants to the community without contravening the intent of section 4943 of the Internal Revenue Code.

Thank you, Mr. Chairman and Members of the Subcommittee.

June 7, 1983

SUBMISSION OF
THE MORRIS & GWENDOLYN CAFRITZ FOUNDATION

This memorandum is submitted on behalf of the Morris and Gwendolyn Cafritz Foundation which is the largest private foundation serving the Washington Metropolitan Area. Since it was founded in 1948, the Cafritz Foundation has made grants totalling over $26 million to many worthwhile organizations active in the arts and humanities, community services, education and health.

The Foundation is a major supporter of The National Symphony, The Corcoran Art Gallery, The Capital Children's Museum, Arena Stage, The National Park Foundation, The Kennedy Center, Ford's Theater, WETA, The Folger Theater, The Washington Opera, Columbia Hospital for Women, the Visiting Nurse Association, the American Red Cross, Gallaudet College, local universities and schools, and many other organizations. All grant requests are reviewed and approved by a panel of 12 distinguished citizens including the Secretary of The Smithsonian Institution, the Director of the National Gallery, and The Librarian of Congress.

In order to prevent abuses by exempt organizations, Section 4943 imposes a prohibitive excise tax on excess business holdings of a private foundation. Special transition rules apply to large holdings that existed as of May 26, 1969.

The Cafritz Foundation requests correction of a disparity in the transition rules whereby the holdings of the private foundation and disqualified persons are aggregated for the 75% stock interest - fifteen year transition period but not for the 95% stock interest - twenty year transition period.

The transition periods are set forth in Section 4943(c)(4)(B) as follows:

> (B) Any interest in a business enterprise which a private foundation holds on May 26, 1969, if the private foundation on such date has excess business holdings, shall (while held by the foundation) be treated as held by a disqualified person (rather than by the private foundation) --
>
> (i) during the 20-year period beginning on such date, if the private foundaton has more than a 95 percent voting stock interest on such date,
>
> (ii) except as provided in clause (i), during the 15-year period beginning on such date, if the foundation and all disqualified persons have more than a 75 percent voting stock interest (or more than a 75 percent profits or beneficial interest in the case of any unincorporated enterprise) on such date or more than a 75 percent interest in the value of all outstanding shares of all classes of stock (or more than a 75 percent capital interest in the case of a partnership or joint venture) on such date * * * (Emphasis added)

The Cafritz Foundation requests that the two subsections be conformed by adding the following underscored language to Subsection (i):

> (i) during the twenty year period beginning on such date, if the private foundation and all disqualified persons have more than a 95% voting stock interest on such date . . .*/

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*/ Alternatively, Subsection (i) could be conformed so as to track the qualifying language of Subsection (ii).

The effect of the amendment would be to extend for five years, until May 26, 1989, the time within which the Cafritz Foundation must dispose of its remaining excess business holdings.

Unless Section 4943 is amended as proposed -- or there is some other provision for a five-year extension for disposal of excess business holdings of private foundations generally -- Section 4943 will have a harsh impact upon the Cafritz Foundation, i.e., by May 26, 1984, the Cafritz Foundation must sell -- probably at a substantial loss -- most of its two-thirds stock interest in the Cafritz Company, a management company which efficiently manages and conserves the Foundation's widespread real estate holdings.

The Cafritz Foundation Holdings

The Cafritz Foundation was the principal beneficiary under the Will of Morris Cafritz, a major builder in the Washington area who died in 1964 leaving an estate of very substantial value. Mr. Cafritz' Will adopted an estate plan, the effect of which was the distribution of a fractional two-thirds interest in most of Mr. Cafritz' assets to the Cafritz Foundation with the remaining interest in each asset going to a marital trust. Some five years later, when the Tax Reform Act of 1969 was enacted, the marital trust became a "disqualified person".

Mr. Cafritz' estate included a hotel, a major construction company, a real estate management company and a number of passive real estate investment properties, including office buildings, apartment buildings, warehouses, two small shopping centers, and unimproved land. Since 1969, the hotel has been sold, all construction and development activities have been terminated and several undeveloped or underdeveloped tracts of land have been sold.

The principal remaining asset which falls within the 1969 Act's definition of an "excess business holding" is the Foundation's two-thirds stock interest in the Cafritz Company which primarily manages and conserves the real estate investment properties owned by the Foundation and marital trust.*/ Over 50% of the gross management income of the Cafritz Company is derived from management of the properties which passed under the Will of Morris Cafritz. In large part as a result of the Cafritz Company's efficient management of those properties, the Foundation's income and its charitable contributions have increased significantly through the years.

To maintain economy of scale, the Company manages other properties. The Company enjoys no advantage in competing for outside business by reason of its being owned by the Foundation. On the contrary, it is required to maximize current earnings which are fully taxed and distributed as dividends.

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*/ The Company has an insurance subsidiary, a major activity of which is to obtain insurance for properties owned by the Foundation and marital trust.

No Basis for the Disparity

We have reviewed the legislative history and have not found any explanation why the interests of a private foundation and disqualified persons are aggregated for purposes of qualifying for the 75% fifteen-year transition period but not for the 95% twenty-year transition period. The fifteen-year period for divestiture in the case of a 75% voting interest by a private foundation and all disqualified persons was added by the Senate Finance Committee; it had not appeared in the bill as enacted by the House. In Sen. Rep. No. 91-552, 91st Cong., 1st Sess., as reprinted in 1969-3 C.B. 423, 451, the reason for the addition of the fifteen-year period in this situation was explained as follows:

> This modification was provided by the [Senate Finance] committee because the practical difficulties in disposing of a company's equity are apt to be substantial where the foundation owns the bulk of the company's stock.

The twenty-year period for divestment when the private foundation owns directly more than a 95% voting stock interest was added by the Conference Committee without any explanation. See Conf. Rep. No. 91-782, 91st Cong., 1st Sess., as reprinted in 1969-3 C.B. 644, 647.

At the end of the twenty- or fifteen-year first phase, there is a second fifteen-year phase during which the private foundation and all disqualified persons may continue to own in the aggregate no more than a 50% interest.*/

While the legislative history does not refer to the twenty-year first phase transition period, Congress presumably recognized that it would be difficult for a private foundation to reduce a holding as large as 95% to 50% within the fifteen-year period. It is even more difficult, however, to meet the 50% second phase holding limit where over 95% of a stock is not under the exclusive control of the private foundation, but rather is shared with a disqualified person (in this case a trust).

The trustees of the marital trust are concerned that they cannot prudently sell its 33-1/3% stock interest in Cafritz Company. The trust has an interest in retaining ownership of the stock because Cafritz Company effectively manages properties in which the trust has a one-third interest. Also, a minority interest in a closely held real estate management company cannot normally be sold except at less than its proportionate part of the corporation's total fair market value so there would be a likely depletion of trust corpus.

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*/ At the end of the second phase, the combined ownership limit drops to 35%.

The risk of loss in a sale is particularly high in the current depressed real estate market because the income and, therefore, the value, of a real estate management company is directly tied to the level of rentals in the properties managed. While Mrs. Cafritz would be willing to consent to such a sale to benefit the Foundation, this would not immunize the trustees from possible liability to remainderman in connection with such a sale.

The Harm to the Cafritz Foundation

If the trustees adhere to the standards applicable to a fiduciary and do not sell the trust's Cafritz Company stock, the Foundation will be compelled to dispose of three quarters of its stock in the company by May 26, 1984 leaving the Foundation with only a 16-2/3% stock interest. The sale must be made to a third party who is not a disqualified person and the Foundation thereafter could not increase its interest in Cafritz Company to more than a 20% holding.*/

With such a small remaining minority ownership position, the Foundation will not be assured of a sufficient voice in the new management of the Cafritz Company to protect its interest in seeing that its properties continue to be managed in the same efficient manner.

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*/ Once its holdings are reduced, the Foundation's ownership could not be increased on a permanent basis to more than 20% which is the aggregate holdings limit applicable to post 1969 stock acquisitions.

In such circumstance, it would be unwise for the Foundation to give a binding assurance that it will continue to use the services of the Cafritz Company for any extended period. On the other hand, the Foundation's properties account for such a large portion of the Cafritz Company revenues that such an assurance by the Foundation is necessary to make the Cafritz Company stock marketable at a reasonable price.

Thus, the Cafritz Foundation is not faced merely with being required to sell three quarters of its Cafritz Company stock in a depressed real estate market; it is also faced with either committing to continued dealing with a management company in which it will have only a small ownership interest -- thereby possibly jeopardizing effective supervision of its investment properties -- or not making such a commitment and taking an immediate further substantial loss on the sale of its Cafritz Company stock.

If the Foundation had five more years to reduce its first phase holdings, it is conceivable that the problem will resolve itself. Upon the demise of the beneficiary of the marital trust, all of the trust's stock in the Cafritz Company could be distributed to the Foundation. The Foundation could then dispose of one half of the stock with no substantial loss in value because it would then be in a position to give an appropriate assurance as to continued management of its properties by the Cafritz Company.

No Adverse Effect and No Revenue Effect

The amendment will not give rise to any abuse the Act sought to prevent. The concern was that if a foundation owns a business it might (a) ignore the production of income to be used for charitable purposes and (b) unfairly compete with other businesses whose owners must pay taxes on the income they realize. See Summary of H.R. 13270, prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and Committee on Finance for Use by the Committee on Finance (91st Cong., 1st Sess., August 18, 1969). As shown above, the Cafritz Foundation has significantly increased its income for charitable purposes in large part through efficient management of its properties by Cafritz Company. Moreover, the Cafritz Company has realized no competitive advantage by reason of its being owned by the Foundation and the marital trust. On the contrary, it has been required to maximize its income, to pay full corporate income taxes on that income and to distribute fully the balance to its shareholders. Finally, the Cafritz Company has not engaged in any borrowing or other financing, directly or indirectly from the Foundation, from which it could increase its business base in competition with other real estate management companies.

Reasons for the Amendment

1. The proposed amendment will correct an unexplained disparity in the transition rules whereby pre-existing business

holdings of a private foundation and disqualified persons are aggregated for purposes of the 75% fifteen-year transition period but not for the 95% twenty-year period.

2. The proposed amendment is consistent with the purpose of the twenty-year transition period. Congress recognized that it would be difficult for a private foundation to reduce a holding as large as 95% to 50% within the fifteen-year period. It is even more difficult, however, to meet the 50% second phase holding limit where over 95% of a stock is not under the exclusive control of the private foundation, but rather is shared with a disqualified person (in this case a trust).

3. The proposed amendment will alleviate the substantial hardship to the Cafritz Foundation which would be created by an immediate forced sale of substantially all its stock in a company that effectively manages the Foundation's widespread real estate holdings.

4. The proposed amendment would neither give rise to any of the abuses which the statute was intended to rectify nor have any adverse revenue effect. Rather, it will allow the largest private foundation serving the metropolitan Washington area to continue to preserve and protect its passive investments and continue its substantial grants to the community without contravening the intent of section 4943 of the Internal Revenue Code.

STATEMENT OF NORMAN A. SUGARMAN, BAKER & HOSTETLER, WASHINGTON, D.C., ON BEHALF OF THE KNIGHT FOUNDATION

Mr. SUGARMAN. Thank you, Mr. Chairman. My name is Norman A. Sugarman. I am a partner in the law firm of Baker & Hostetler. I formerly served as an Assistant Commissioner of Internal Revenue, the duties of which included supervision of exempt organization matters, among others. I am coauthor of a book published by the American Law Institute and American Bar Association on "Tax Exempt Charitable Organizations."

We represent the Knight Foundation of Akron, Ohio. In my nearly 30 years of private practice we have worked with and provide advice to a great many other charitable and educational organizations, both private foundations and public charities.

The representative of the Treasury Department has indicated that Treasury does not want the IRS to be in the business of regulating the holdings of foundations. But the fact of the matter is that the IRS is in that business. The IRS is regulating holdings and has the power to force divestiture.

I think the heart of the problem is that section 4943 has created more difficulties in its application than any other single provision enacted in the Tax Reform Act of 1969. However, I realize that today's hearing is devoted to just one subsection, 4943(c)(6), relating to this 5-year period for divestiture. I welcome the opportunity to speak on that subject and in favor of the idea of the bill before you. At least its enactment would be one small step forward for mankind.

There are basically four reasons for change in this 5-year provision. First, and most fundamentally, it is contrary to our national policy to encourage greater private sector support for charity. It has the effect of discouraging that support because any donor who would be advised to give substantial stock in a family business to a foundation should also recognize that it is opening up that holding to a forced sale, which is neither good for the foundation or the community or for the business.

The second reason is that the 5-year period is wholly inadequate. It is not actually 5 years, because when there is a substantial holding involved, the preparation time, the marketing time, and all the other factors you heard about this morning have to be taken into account.

In addition to the MacArthur Foundation, let me give the example of the *Continental Water Company* case, which is a published case decided last year by the Court of Claims. After the enactment of the 1969 act in 1970 or shortly thereafter, that business, which was owned wholly by a foundation, was proposed to be sold. The foundation obtained appraisals from very reputable firms. They asked for not only the fair market value—they proposed it to be sold at 2 percent over fair market value, or the highest price available, whichever was higher. Since the sale was to a group which would include disqualified persons, an advance ruling was obtained from the IRS with regard to the method valuation, which the IRS approved. Nevertheless, after the returns were filed, the sale was attacked by the Internal Revenue Service, and only last year, 12 years after the process began, was the matter finally put to rest.

I suggest that anyone seeing that record would recognize that 5 years is much too short, unless they simply don't care how the business is disposed of or what eventually goes to charity.

The third reason for needing an extension is that our economic conditions today are substantially different from what they were in 1969. One has only to witness the gyrations in the stock market to realize that, as well as to see the new businesses which are upon us, and the developments in business, many of which were unheard of in 1969.

Finally, the fourth reason is that the provision fails to take into account the size or significance of the holding. This is the essence of the MacArthur Foundation's problem. There is one rule, whether it is for 100 shares worth $10,000 or whether it is for all of the stock of a corporation valued possibly in the billions.

In contrast, the statute itself provides a flexible period in connection with holdings which existed on May 26, 1969. There are transitional rules of 10 years, 15 years, 20 years, depending on the size of the holdings. And even so in those cases, 10, 15, and 20, are not the limits, because as long as the holdings are under 50 percent, or in some cases 35 percent of the stock of a corporation, they may be held indefinitely.

So Congress has already recognized the need for flexibility and for an extended period where the size is substantial.

While I support the idea of S. 562, I would suggest that two things are needed. One is that there should be an extension for a fixed additional period, and I would recommend 15 years. The first reason I would recommend 15 years is that it happens to be the midpoint between the 10 and 20 years which are already in the statute for substantial holdings on May 26, 1969. Second, it is likely to eliminate the need for a foundation to come back to this committee for additional extensions and to minimize resort to any discretionary authority of the IRS in cases in which the fixed period is not sufficient.

I would secondly recommend that we do keep the flexibility of authorizing the Treasury Department to grant extensions. This is an important area. It requires some safety value for extensions in unusual and meritorious cases.

In summary, I think the fundamental question is: Do we want to at this time encourage the private sector to give greater support for charity and for the creation of new foundations. Many of the foundations in existence today would not be in existence had this law been in effect back in the early years of this century or in the 1920's. I think we need a reexamination of the policy of the 1969 act to provide incentives and to provide encouragement, not disincentives. And the first step in that direction should be the extension of this 5-year period. Thank you.

Senator PACKWOOD. Mr. Sugarman, thank you.

[The prepared written statement of Mr. Sugarman follows:]

STATEMENT
OF
NORMAN A. SUGARMAN
WASHINGTON, D.C.
TO
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
AT HEARINGS ON S. 562
June 7, 1983

My name is Norman A. Sugarman. I am a partner in the law firm of Baker & Hostetler. I formerly served as Assistant Commissioner of Internal Revenue. My duties included supervising the functions of the Internal Revenue Service with respect to tax-exempt organizations. In nearly 30 years of private practice I have worked with and advised many charitable organizations, both private foundations and public charities. I am co-author of a book published by the American Law Institute-American Bar Association on the subject "Tax Exempt Charitable Organizations."

I welcome this opportunity to speak on S. 562. The recommendations which I shall make are based on experience and problems of a number of foundations under Internal Revenue Code § 4943 as enacted in the Tax Reform Act of 1969.

Section 4943 puts the IRS in the business of regulating, and in some cases forcing the divestiture of, holdings of foundations in business enterprises. S. 562 is directed to correcting one of many problems in the application of § 4943; and I am glad to speak today in support of the one corrective step reflected in the approach taken in S. 562.

The Bill would amend § 4943(c)(6). This provision presently provides a 5-year grace period during which a private foundation may continue to hold stock in a business enterprise received, generally, by gift or bequest where such holding would otherwise be an "excess business holding" under the limitations contained in § 4943 on business holdings. The amendment would authorize the Treasury Department to grant extensions of time beyond the 5-year period in order to permit an orderly disposition of such holdings.

I would like to comment first on the need for corrective legislation, and second on the form which the corrective action should take.

NEED FOR CORRECTIVE LEGISLATION

The following reasons compel the conclusion that § 4943(c)(6) should be corrected to provide relief from the arbitrary 5-year limitation under the present law.

1. The section is presently contrary to national policy to encourage private sector support of charity. Much could be said about the overall adverse effect of § 4943 in discouraging the transfer of wealth to charitable purposes; but § 4943(c)(6) is a particular offender because a would-be donor, who might otherwise be encouraged to contribute stock of a family business to a foundation, would usually be discouraged by the 5 year limitation from doing so. This is particularly the case where the holdings are substantial. A forced early divestiture is generally neither in the best interests of the foundation, the business in which it has an investment, nor the community or communities which are served by the foundation or its distributee charities. The case before the Committee, that of the MacArthur Foundation, is an example of the difficulties and the possible loss in value to charity that stem from the transfer of substantial business holdings to a foundation.

The making of charitable gifts is voluntary. There are many alternatives available to a donor as well as incentives not to contribute to a foundation, particularly with the reduction in the capital gain rate to a 20% maximum, the allowance of an unlimited marital deduction, and the reduction in estate tax rates generally. All of these factors combine to say to a would-be donor, "Why bother to make a substantial gift to charity, particularly if a gift to a private foundation can result in an untimely forced divestiture?" The laws should encourage rather than discourage the creation of new foundations for charitable purposes and the gifts to them of substantial holdings. There are sufficient other legal restraints, under state law and in Chapter 42 of the Internal Revenue Code, to minimize or prevent abuses.

2. The present 5-year period is less than 5 years as a practical matter. While the statute seemingly provides a 5-year period for disposition of "excess business holdings" received under the circumstance described in § 4943(c)(6), the fact is that the period is much less than that. Particularly where there is a substantial gift of stock, the proper marketing of that stock is not a simple matter. These decisions cannot be idly made. The trustees of the foundation have a fiduciary responsibility to make the sale at the highest price reasonably obtainable; realizing that goal can be very difficult and time consuming. In

some cases, state regulatory authorities may have to be consulted or their approval sought and in other cases the securities laws at the state and federal level may slow down the process or otherwise make it difficult.

There are a great many factors involved in the timing of a sale, selecting the right buyer and negotiating or determining the price and other terms. If a private sale is to be made, then negotiations and finding the "right customer" may take a considerable period of time. If the stock is of a type for which a public offering is appropriate, the time from idea to fruition may be a year, and, of course, depending on the market conditions, could be considerably longer. If the best way of marketing stock is through a secondary offering, approval and assistance from the issuing corporation is necessary, and the timing of such assistance and secondary offering may very well depend upon the corporation's own plans and necessities with regard to its financing. It is not unusual, where there is a right to a secondary, to provide the corporation a substantial period of time, such as a year, within which to determine the timing of any offering after the request is made by the stockholder.

Finally, the point needs to be made that any sale of a foundation's excess business holding required by § 4943(c)(6) may have to take into account other holdings by the foundation. It may be necessary or advantageous not simply to sell a particular block of shares received by gift or bequest but a bigger holding in the corporation which the foundation would otherwise be permitted to hold under § 4943. Where substantial holdings are involved the problems in finding the right customer at the right time are multiplied. Additional considerations are also required in such cases as to the impact on a community, on the continuity of management of a business and on the welfare of employees, particularly if a sale of a large block of stock might shift or create uncertainty as to the control of a corporation. Given all these factors, in many cases the time for disposition of shares is, in actuality, only a fraction of the 5-year period.

3. An extended period is needed to preserve values for charity. Economic conditions in recent years have certainly demonstrated that five years is a very short period of time in which to determine the best market or proper time for the disposition of an interest in a business. As one indicator, since 1969, the stock market has fluctuated substantially. The Dow Jones Industrial Average was at a low of 577 in 1974, but two years later, in 1976,

it reached a high of 1014; and in 1980 it was back to a low of 759 and now, less than three years later, it is approximately at 1230.[1]

In addition in this relatively brief period, new businesses have been created and enterprises have changed substantially. Businesses have expanded into new fields which were practically unheard of in 1969, such as bio-tech engineering, overnight courier delivery services, and electronic communications. If you were a fiduciary, wouldn't you like to have more than a few years in which to make a decision, when to sell a substantial holding in a corporation and invest in other companies or industries?

The fact is that the arbitrary limitation under §4943(c)(6) is inconsistent in many cases with the obligation of a fiduciary to determine carefully when and how to dispose of business holdings in today's very complex business and economic situation. If it is necessary to have § 4943 (c)(6) to force divestiture of stock received by gift or bequest, at least the statute should be more attuned the duties of a fiduciary under current conditions.

4. The statute presently fails to take into account the size or significance of the holding. As previously indicated, not only the making of decisions to dispose of stock, but also the process of doing so varies, depending upon the size of the block of stock involved. The statute simply has a flat 5-year provision regardless of whether the stock involved is 100 shares with a value of $10,000 or 10,000 shares with a value of $10 million or 100% of the stock with a value of $100 million.

In contrast, § 4943 as enacted in 1969, provides with respect to grandfathered holdings, i.e., those held on May 26, 1969, various transitional periods to reduce such holdings to a 50% limit. These periods are 10 years, 15 years or 20 years, depending on the percentage of stock held. There is no good reason that § 4943(c)(6) should not recognize the same problem and provide a different rule than simply a 5-year cut-off.

The case of Continental Water Co., v. U.S.[2] "treated" all to an example of the difficulties and time consuming problems under Chapter 42 of the Code in seeking to dispose of stock. The stock of this company was 100% owned by a foundation. In 1970 or 1971, the Trustees of the Foundation started a process to dispose of the stock. After investigation, and with the help of experts, it was determined to sell the stock for cash to a company formed by a group of investors, which included disqualified persons. The price would be the higher of the best price available or 2% over fair market value as determined by two appraisals. Although an advance ruling was obtained from the IRS approving the process involved in the sale and pricing, it was nevertheless attacked by the IRS on audit. On April 2, 1982 a Trial Judge of the Court of Claims upheld the Foundation's position, and a final decision favorable to the taxpayer was rendered by the Court on June 11, 1982. All together it took a period of at least 12 years, from the beginning of preparations to sell until court approval, for this sale transaction to pass muster under Chapter 42 of the Code.

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[1] From Perspective, May, 1983, a publication of A. G. Becker Paribas.

[2] U.S. Court of Claims, 1982, 50 AFTR 2nd 82-5128.

Given this reported case, how can any donor be encouraged to leave a substantial block of stock to a foundation knowing that that statute will allow only 5 years for disposition?

RECOMMENDED FORM OF CORRECTION

S. 562 would correct the existing law by giving the Service discretion to extend the 5-year period if the Service determines, based on certain standards, that an extension is necessary to permit an orderly disposition of excess business holdings. While I support the idea behind S. 562, I recommend that the amendment provide relief in the following two forms: (1) increasing the 5-year period to a longer stated period; and (2) granting the Treasury Department discretionary authority to make extensions beyond such period as needed.

The reasons for changing the 5-year period by statute to a longer period are not only that such a longer period is justified but also because it would reduce the burden on the IRS in applying discretionary authority.

For reasons previously stated, the 5-year period is clearly inadequate. There is precedent in the grandfather provisions of § 4943 for a period of 10, 15, or 20 years. On balance, I recommend 15 years, because it is necessary that the law continue to encourage the making of charitable gifts of stock. The public interest is better served by such encouragement than by making it more difficult for donors to transfer wealth in support of charitable purposes.

After all, what is the great harm in a foundation receiving a gift of stock in a business corporation and having a reasonable period of time in which to hold such stock while determining how it may dispose of it most advantageously consistent with its exempt purposes. There are ample provisions to prevent abuses during such a holding. Section 4941 imposes penalties on self-dealing. Section 4943 requires annual payouts for charitable purposes in a reasonable amount, § 4945 places limitations on expenditures for program purposes. State laws have become increasingly effective in seeing that fiduciary standards are applied. Alert donee organizations in the private sector are quick to call to the attention of federal and state authorities situations in which foundations are not making distributions consistent with their privileges as tax-exempt organizations. The situation is substantially different today than it was in 1969 and it is time that the public interest in creating more charitable funds - not fewer - is recognized.

A further reason for extending the period to 15 years is that the situations in which the Service would then be called upon to exercise discretionary authority would be substantially reduced. I recognize that there is resistance to the granting of discretionary authority to the IRS. Such resistance may even come from the IRS. However, I believe that some discretionary authority is still necessary. The tax laws should not be enacted simply for the administrative convenience of the IRS. It has many tasks involving the exercise of judgment and it generally handles them very well.

As a practical matter, the Service is exercising discretion every day in the operation of § 4943. The statute is very poorly drafted and requires interpretation in numerous areas. As a matter of fact, the very section with which we are dealing, § 4943(c)(6), is one which is wide open for interpretation in a very important area. What happens when a business corporation in which a foundation owns stock expands or acquires another corporation; does the 5-year period apply to the "new" business interest acquired indirectly by the foundation? I suggest that this is a bigger and a wider area of discretion open to the Service than the more simple matter of the timing of disposition of stock with which we are dealing here.

The public interest in encouraging charitable gifts and making sure that the charity realizes full value, to the extent reasonably possible, requires that there be some safety valve in the operation of the rule requiring divestiture of stock received by gift or bequest.

I believe that, given the authority, the IRS could develop standards under which it would apply the intent of Congress in granting extensions under an amended § 4943(c)(6) in meritorious cases.

With respect to the particular standards stated in S. 562 for application by the Service, I believe that these could be clarified and improved and I shall submit for the record of these hearings some specific suggestions for this purpose.

CONCLUSION

In summary, legislation to correct § 4943(c)(6) deserves the support of this Committee. I recommend that S. 562 be modified to increase the 5-year period under § 4943(c)(6) to 15 years and to provide the necessary discretionary authority in the Treasury Department to grant further extensions when it is demonstrated that disposition within a shorter period is not reasonably feasible.

Senator PACKWOOD. I was impressed by the position of last year and will support it again this year. Let me ask you this. Have arrangements been made to have a hearing in the House and testimony?

Mr. SUGARMAN. The House hearing will be on June 27 and 28.

Senator PACKWOOD. Good.

Mr. SUGARMAN. And I am sure there will be more about 4943, which is a key provision.

Senator PACKWOOD. Often the House will not accept things in conference they haven't heard. They don't necessarily have to have adopted them, but if they have not heard them, almost as a matter of preemptive right in initiating tax legislation, it is very difficult to get them to consider it. So I am glad to know you are going to have hearings. Dave?

Senator DURENBERGER. By way of observation, Mr. Chairman, you know very well the amount of time that has been consumed both in this subcommittee that you chair and every time we have a markup on a tax bill dealing with the issue that has been presented to us here in a specific form and then in the general form that it has been testified to here this morning. I am deeply concerned obviously, as I mentioned to several of you and the last time I think to Mr. Joseph, who said that for some reason or rather we cannot mount enough concern in the appropriate places to affect broad change in the 1969 act. We always come to the Council on Foundations, or some place else, and say wouldn't you come forward and carry the flag for a change? But somewhere out there we are missing perhaps some stronger lobbying force on behalf of the private sector. I guess we need to get this away from MacArthur or, in Minnesota's case, formal or bland on where communities are living or dying off of the appropriate handling of these kinds of matters, and get it out where we can all look at it in terms of I think as Mr. Sugarman and others have testified in terms of the role the private sector is going to play it.

It appears to me that some of the concerns that were expressed in 1969 are no longer valid; maybe some of the others are. I know there is a deep concern on the part of many, articulated probably by the Council on Corporate or Foundation Responsibility, whatever it is, that there are changes that ought to take place in the disclosure side in terms of foundation giving and so forth. And I would just use this occasion to urge all of you and the people that you represent, as you urge us, to put a little pressure on this process to come to grips with a terribly important issue that faces this country, and that is the willingness of a large part of this country to devote private resources to the solution of problems, rather than governmental.

Dr. **CORBALLY**. Mr. Chairman.

Senator **PACKWOOD**. Dr. Corbally.

Dr. **CORBALLY**. I would agree completely with your comments. I have had the privilege of being involved in the hearing process for many years, and I have been delighted to find that this particular need is one that needs little philosophical or conceptual opposition. And to one extent our concern at the MacArthur Foundation as we move into the last few months of the 5-year period is that what we consider to be a rather simple need for an extension of time under very special circumstances, we are concerned that that not get lost in the equally important broad philosophical concerns that you mentioned. And while we don't wish to separate the concern of the Foundation or the involvement of the Foundation in the agenda, if you will, on the Council on Foundations and our other colleague foundations, we do, as we watch perspective purchasers watch our clock running and become less interested in what we consider to be fair values, hope that the rather simple problem will not get lost in the broad philosophical issues which are also important.

Mr. **JOSEPH**. Mr. Chairman, could I add a footnote to that as well?

Senator **PACKWOOD**. Go right ahead, Mr. Joseph.

Mr. **JOSEPH**. I appreciate very much Senator Durenberger's comments. He and I have had a chance to discuss this before. I might add that there is a difference of opinion within the foundation field in regard to how effectively the public interest is served by the rules that relate to pre-1969 holdings. But on the issue before this subcommittee today, the divestiture requirement for post-1969 holdings, there is a unanimous feeling that this deadline is too restrictive. And so I don't want to confuse all of the issues that are out there and are concerns of grant makers with this particular issue on which there is a common agreement.

Mr. **SUGARMAN**. Mr. Chairman.

Senator **PACKWOOD**. Go right ahead, Mr. Sugarman.

Mr. **SUGARMAN**. I had one comment. To follow up on the statement that Dr. Corbally has made, I think it is important to underscore the fact that section 4943, including the particular provision we are talking about today, has made takeover targets of a lot of businesses. I don't mind saying that one of our clients has asked us to watch some of these developments in terms of a particular business they may be interested in buying, and if Congress does not provide relief by way of an extension, they will be right there to buy it at a fire sale. There is a reluctance to come forward in some of these cases because of the very fact it does make takeover targets out of the named businesses. And I suggest to you that that result is exactly contrary to what Congress intended in 1969, which, in effect, was to get foundations out of the business. This puts them into it feet first.

Senator **Packwood**. I agree with you completely. I will do what I can to get it through the Senate. And I wish you good luck in the House. Gentlemen, thank you very much.

We will wait just a minute, gentlemen, until the room is cleared. [Pause.]

Senator **Packwood**. I ask unanimous consent that a statement of Don Moore, who shares, I think, the views of the panel, be placed in the record at this time. He could not be here today. He is an old acquaintance of mine from Oregon.

[The prepared written statement of Mr. Moore follows:]

Moore National Lease,
Portland, Oreg., June 3, 1983.

Senator Bob Packwood,
U.S. Senator, 259 Russell Building, Washington, D.C.

Dear Senator Packwood: I am asking for help for the automobile leasing industry; particularly those that serve the commercial and industrial fleets of our country.

As you are well aware, with your help, we got Section 210 of the Tax Equity and Finance Responsibility Act of 1982 (TEFRA) passed. Now the IRS, contrary to the wording of that ruling have published a notice of proposed rulemaking under which it stated its intention to reverse the rule of Section 210 and deny lease treatment to motor vehicle operating lease agreements of the kind covered by Section 210. The terminal rental adjustment clause (TRAC) lease came into being in the 1950's, and has been in use ever since. It evolved naturally in the day to day negotiation exchange to fit the needs of the market place.

1. It allows the lessor to provide the vehicles to the lessee (user) at the lowest possible cost because it is not necessary to factor into the rate the contingencies of changing market conditions and condition of the vehicle at termination after two or three years usage.
    a. It is impossible to forecast accurately market condition 2 or 3 years in the future.
    b. The lessor can operate on a smaller margin.
2. It places responsibility on the lessee to maintain the vehicle and handle it properly.
    a. Allows simpler documentation.
    b. Lessee's end cost will hinge on how he treats the vehicle.

The ability the TRAC lease document gives a lessor to recover from the lessee for hard use or abuse or market conditions enables the small business man to participate in this business. It would have been impossible for me to raise the necessary capital at the rates and terms necessary to compete in this business without the TRAC lease which allows the financial institutions to look through me and to the financial strength of my customer. Currently there are 40 auto lease listings in just the Portland yellow pages. Two of these are offices of national companies of considerable size. The balance of them are small operations.

The study which you probably have seen and I am enclosing that our industry commissioned Haskins & Sells to do, would seem to substantiate what we have been saying for several years. "There is great need for the TRAC lease in the market place and the IRS has nothing to gain by the change they continue to seek."

I hope we will have your support in the matter of the bill introduced by Mr. Durenberger to continue the TRAC lease as a valid lease. Thank you.

Sincerely,

Donald W. Moore, *President.*

Senator **Packwood**. And Senator Durenberger will complete the chairing of this panel today. I have a doctor's appointment at 10:30. And we will take the panel in the order that they are shown: Mr. Penn, Mr. Cartwright, Mr. Weimer, Dr. Brannon, and Mr. Nolan.

Mr. Penn, do you want to start?

STATEMENT OF A. SAMUEL PENN, PRESIDENT, AMERICAN AUTOMOBILE LEASING ASSOCIATION

Mr. **Penn**. Yes. Thank you, Mr. Chairman. Before I begin, if I may, I would like to introduce, seated behind me, a group of vehicle lessors that are here to assist me in answering any questions that you might have.

Senator **Packwood**. I appreciate it. And I would appreciate it if the panel would also, in addition to their comments, direct themselves to the comments of the Treasury Department so that we can distinguish them.

Mr. **Penn**. Thank you, sir.

Senator **Packwood**. Go right ahead.

Mr. **Penn**. Seated behind me is Mr. Bernard Goldman, who is the president of Bankers Leasing.

Senator **Packwood**. Mr. Goldman.

Mr. **Penn**. James S. Frank, president of Wheels, Inc.; John W. Salzer, president of Dresser Leasing Corp; Murray H. Hendel, senior vice president of Gelco Corp.; Donald F. Gorman, vice president, Leaseway Transportation Corp.; Raymond H. Rehor, vice president for taxes for Leaseway Transportation Corp.; Thomas J. McHugh, vice president from Dart and Kraft, Inc.; Roger A. Murch, director of Government relations for National Car Rental. These are all seated behind me and they are here to assist and answer any questions that you might have.

Senator **Packwood**. Thank you very much.

Senator **Durenberger**. Mr. Chairman, before he begins I want to express my appreciation to you. I have to keep doing this because you are so good to give us so much of your time.

Senator **Packwood**. You have so many bills. [Laughter.]

Senator **Durenberger**. Well, that is on behalf of everybody on the committee. But to thank you for having these hearings today and to ask your permission for two things, one, that my full statement be inserted in the record, and that I be permitted to submit a list of questions to Treasury in response to their testimony this morning, and that they be asked to give us some responses for the record within the next 30 days.

Senator **Packwood**. Without objection.

[The prepared statement of Senator Durenberger follows:]

Prepared Statement of Senator Durenberger for Hearings on Terminal Rental Adjustment Clause Bill S. 1161

Mr. Chairman, I want to thank you for having these hearings today on S. 1161. Many of us here on the Finance Committee support this bill. It settles a controversy that should never have arisen. We thought the Congress settled it last year, under the leadership of Senators Bentsen and Armstrong, when we passed Section 210 of the Tax Equity and Fiscal Responsibility Act.

This bill will make clear that a terminal rental adjustment clause (TRAC) in a motor vehicle operating lease will not be taken into account in determining whether an agreement is a lease for federal tax purposes if the lessor either is personally liable for repayment or has pledged certain other property as security for amounts borrowed to finance the acquisition of the property. The bill would be effective for all agreements regardless of whether they were signed before or after the effective date of the act.

For the purposes of our bill a terminal rental adjustment clause is a provision in an agreement that permits or requires an adjustment in the rental price based on the amount realized in the disposition of the property at the termination of the lease. This form of lease is used for approximately 4 million vehicles according to the American Automotive Leasing Association (AALA).

The history of TRAC has been torturous these last few years. In 1979 the Internal Revenue Service reversed a long-standing audit practice in a private letter ruling denying lease treatment both retroactively and prospectively to agreements containing a terminal rental adjustment clause. This letter was not made public until May 1980. In 1981 the Tax Court overruled the Service in *Swift Dodge* v *Commissioner.*

While the decision was on appeal, Congress stepped in last year during TEFRA and included a provision stating loud and clear that the Service was not to disallow TRAC leases retroactively and was not to disallow such leases prospectively until new regulations were issued. It was the understanding of many of us, including my distinguished colleague from Texas and the sponsors of that provision, Mr. Bentsen, that the Treasury should issue new regulations only after a major policy level study of the economic and tax consequences and only under extraordinary circumstances.

Despite Congress' intent, the Treasury issued regulations only eleven weeks after the passage of TEFRA and without any major study of the effects of the change. These regulations would deny lease treatment for tax purposes of leases containing a terminal rental adjustment clause.

If the Treasury had done the study of the economic effect of such regulations, they would have found devastating results. In the short run, the fact of proposing regulations with an effective date of the date first issued has caused turmoil in the industry. A wait and see attitude is widespread. After all, final regulations along the lines of the proposed regulations will mean that deals must be renegotiated and contracts rewritten. Unless a user has an urgent need for an automobile, the company is likely to wait until more certainty is available on actual costs.

Some say companies will delay three months, others say six to nine months. A three-month delay alone could result in the loss of 375,000 new car purchases with a sales value of $3.75 billion. The automobile industry certainly cannot afford such losses at this time.

A look at the long-term effect of a denial of lease treatment brings even more staggering economic problems. Denial of lease treatment is likely to discourage leasing generally. According to a study prepared for the American Automotive Leasing Association, business-owned vehicles are held 32 months compared to 28 months for leased vehicles. If businesses delayed four additional months in purchasing new cars, the automobile industry would lose billions of dollars. Even a one-month delay would reduce new car purchases by approximately 57,000 vehicles, which at an average price of $10,000 means $570 million.

Should all the present TRAC leases continue as leases but be recognized for tax purposes as sales, the long-range revenue effect on the Treasury is estimated at $85 million annually. This results from the shift of the investment tax credit and depreciation to the users of the vehicles.

Mr. Chairman, let me note briefly the one real difference between this year's bill and the TEFRA provision. This year vehicles used for either business or personal reasons are eligible for lease treatment. During TEFRA, at Treasury's urging, we included only leases for business purposes. Treasury expressed concern that estimates, which showed no appreciable revenue loss, had been done only on business leases. Given the Finance Committee's concern with revenue impacts, we accepted this modification. However, no sound tax policy exists to treat personal differently from business leases, and such a distinction causes significant administrative complexity requiring the Service to examine the use to which each automobile is put.

Mr. Chairman, in these difficult economic times, the Congress must speak out to end the uncertainty that has engulfed the automobile leasing industry, an uncertainty that has significant ripple effects on the already troubled automobile industry. Failure to do so is likely to bring a revenue loss to the Federal Government and certainly a loss to the country's economy. We can ill afford such adverse consequences from our inaction.

I look forward to hearing the testimony of our distinguished panel that has extensive experience in leasing—both as lessors and lessees.

Senator PACKWOOD. Mr. Penn, go right ahead.

Mr. **Penn**. Thank you, Mr. Chairman. Mr. Chairman, I am the chairman of an ad hoc group of motor vehicle leasors, manufacturers, dealers, workers, and users, and we are all working together in support of prompt enactment of S. 1161.

With me on the panel to answer questions are representatives of motor vehicle fleet leasing companies, and Dale Wickman, counsel to our ad hoc group.

S. 1161 will prevent the IRS from reversing the rule of section 210 of TEFRA that a TRAC clause is not to be taken into account in determining whether certain motor vehicle leases are to be treated as such for tax purposes. A TRAC clause is one where the rent is retroactively adjusted at the end of the lease term by reference to the resale price of the vehicle in relation to its projected value. The bill would also apply to consumer leases that are not now covered by section 210. The course of action being pursued by the IRS will provide no benefit to the Treasury or to the public, but it will cause substantial injury to the motor vehicle industry, to lessors, to new car dealers, to manufacturers, to their workers, and to lessees because of an increase in prices. Furthermore, the IRS has proposed regulations in a manner contrary to the intent of Congress.

Mr. Chairman, we should not be forced to change our business practice that has developed over 30 years. Frankly, we do not understand why the IRS wants us to change a practice that has proven so effective. TRAC leases account for upward of 16 percent of Detroit's motor vehicle output. They comprise 70 percent of all motor vehicle leases because they are, in fact, the most efficient form of vehicle lease. They are designed to insure that the party best able to care for and maintain the vehicle, the lessee, will bear the full cost of use and possible abuse of the vehicle. Vehicle condition, appearance, and the extent of use are the factors that are important in determining resale value of an automobile. Motor vehicle TRAC leases are not tax motivated. Any other form of lease transaction will be less efficient and more expensive. This additional cost will result in a reduction of new vehicle sales. The loss sales will be harmful to lessors, to new car dealers, to manufacturers, to workers, and to the consumers.

It is worth noting, Mr. Chairman, that close to 100 percent of the vehicles used in commercial fleet leases are manufactured here in the United States. There is, in fact, no business, economic or tax policy reason why we should change a wide-spread efficient business practice that has been in use for more than 30 years. The burden should not be on motor vehicle lessors to justify the way they have historically done business. The burden should be on the IRS to show why its proposed change, which will benefit no one and will raise no revenue, justifies the hardship that would be caused to all segments of the motor vehicle industry, its workers, and consumers.

We cannot predict long-range business reaction to an IRS change in the law. We can predict that leases for those few lessees unable to use their tax deductions will be restructured in a way that satisfies IRS guidelines. But we can also predict with certainty a period of substantial disruption during which new car deliveries to our lessees will come to a virtual halt while available alternatives are being studied.

If I may just continue for just a few moments, Mr. Chairman.

Senator **Durenberger**. Go ahead.

Mr. **Penn**. The economic and revenue impact of these alternatives will be explained by Dr. Brannon. He and Emil Sunley, have concluded that S. 1161 will be essentially revenue neutral and may even produce a small revenue gain to the Government. The IRS has acted in a manner contrary to the intent of the Congress. Statements of the principal sponsors of legislation, ultimately enacted as section 210 of TEFRA, clearly indicate that no IRS regulation was to be issued except under extraordinary circumstances supported by major policy level studies. Yet, without having conducted any studies whatsoever, the IRS issued its regulation on TRAC leases less than 3 months after TEFRA was enacted. Enactment of S. 1161 will remove the power of the IRS to change the law and place that policy decision where it belongs, with the Congress. S. 1161 will prevent the IRS from pursuing a course of action that will cause substantial harm and produce no benefit. We urge its enactment. Thank you, Mr. Chairman.

Senator **Durenberger**. Thank you very much, Mr. Penn. Mr. Cartwright, you are next on the list.

[The prepared statement of Mr. Penn follows:]

Statement In Support of S.1161

A. Samuel Penn
Chairman of an Ad Hoc Group of U.S. Motor Vehicle
Lessors, Dealers, Manufacturers, Workers and Users
and
President, American Automotive Leasing Association

Mr. Chairman, Members of the Committee, we thank you for the opportunity to testify today in support of S.1161.

I am testifying in my capacity as chairman of an ad hoc group which includes within its participants a broad cross section of the entire motor vehicle industry -- large and small motor vehicle lessors, automobile dealers, and U.S. motor vehicle manufacturers, workers, and users -- and in my capacity as President of the American Automotive Leasing Association.*/

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*/ The participants in the ad hoc group are: LESSORS - PHH Group, Inc. and affiliates, Baltimore, Maryland; Gelco Corporation and affiliates, Minneapolis, Minnesota; Leaseway Transportation Corporation, Cleveland, Ohio; Wheels, Inc., Chicago, Illinois; Bankers Leasing Corporation (a subsidiary of the Southern Pacific Corporation), San Francisco, California; U.S. Fleet Leasing Company (a subsidiary of U.S. Leasing International), San Francisco, California; National Car Rental Systems (a subsidiary of Household International, Chicago, Illinois), Minneapolis, Minnesota; Dart & Kraft Leasing (a subsidiary of Dart & Kraft, Inc., Chicago, Illinois), Minneapolis, Minnesota; Kerr Management Corp., Denver, Colorado; Glesby Leasing, Houston, Texas; Moore Leasing, Portland, Oregon; AMI Leasing Group, Worcester, Massachusetts, and Providence, Rhode Island; American Automotive Leasing Association (AALA), Milwaukee, Wisconsin, and Washington, D.C.; Dresser Leasing Corporation (a subsidiary of Dresser Industries, Dallas, Texas), Pittsburgh, Pennsylvania; RTR Transportation Corp., Rochester, New York; LESSEES - Various lessee organizations around the country also are cooperating informally in the work of the ad hoc tax group; DEALERS - National Automobile Dealers Association (NADA) and numerous member dealer organizations around the country, Washington, D.C.; MANUFACTURERS - General Motors Corporation, Detroit, Michigan; Ford Motor Company, Detroit, Michigan; Chrysler Corporation, Detroit, Michigan; LABOR - United Auto Workers (UAW), Washington, D.C.

I am Executive Vice President of PHH Group, Inc., which is headquartered in the Baltimore, Maryland, area. Accompanying me today on the panel are presidents and senior executive officers of most of the other major fleet motor vehicle leasing companies. They are Bernard Goldman, President and Chief Executive Officer of Bankers Leasing Corporation, a subsidiary of Southern Pacific Company, headquartered in the San Francisco area; James S. Frank, President and Chief Executive Officer of Wheels, Inc., headquartered in the Chicago area; John W. Salzer, President and Chief Executive Officer of Dresser Leasing Corporation, headquartered in Pittsburgh, Pennsylvania (a subsidiary of Dresser Industries, headquartered in Dallas); Murray H. Hendel, Senior Vice President of Gelco Corporation, headquartered in the Minneapolis area; Donald F. Gorman, Vice President of the Fleet Management Division of Leaseway Transportation Corporation, headquartered in the Cleveland area; Thomas J. McHugh, Director of Taxes of Dart & Kraft Leasing (formerly Gamble Leasing), headquartered in Minneapolis (which is now a subsidiary of Dart & Kraft, Inc., headquartered in the Chicago area); Roger A. Murch, Director of Government Relations for National Car Rental (a subsidiary of Household International), headquartered in the Minneapolis area; and W.H. "Duke" Irvine, Vice President and General Manager of AMI Leasing Group, headquartered in Worcester, Massachusetts, and

Providence, Rhode Island. Also accompanying me is counsel to the ad hoc group, Dale W. Wickham. They are here to answer any questions you may have.

The purpose of the ad hoc group is to support prompt enactment of S.1161. S.1161 makes clear that a terminal rental adjustment clause (TRAC) in a motor vehicle operating lease will not be taken into account in determining whether an agreement is a lease for Federal tax purposes if the lessor either is personally liable for repayment or has pledged certain other property as security for amounts borrowed to finance the acquisition of the property. The bill would be effective for all agreements regardless of whether they were entered into before or after its enactment.

A terminal rental adjustment clause (TRAC) is a provision in an agreement that permits or requires an adjustment in the rental price based on the amount realized on the disposition of the property at the termination of the lease. In a typical TRAC lease transaction, at the end of the lessees' use of a vehicle, the lessor takes the vehicle back from the lessee (who usually wants to be freed of the onerous requirements of motor vehicle ownership including the task of selling it), sells it on the open used car market at the best price obtainable, and then adjusts the rent by paying a refund to or collecting a deficiency from the lessee, to make up for any difference there is between the resale price actually realized from sale of the vehicle on the open market and the estimated or projected resale value of the vehicle that was used by the parties at the beginning of the lease in setting the amount of the rent payments. A typical vehicle TRAC lease transaction is NOT one in which the lessee is given an option to purchase the vehicle at the end of the lease term and certainly is NOT one in which the lessee is given an option to purchase the vehicle at a price that is nominal in relation to its actual market value at the end of the lease term. The TRAC vehicle lease was devised in the market place more than 30 years ago for the non-tax, business purpose of providing a financial incentive to the lessee user, who is the party to the lease transaction who is best able to control the cost of using and caring for the vehicle, to maintain the vehicle properly. That is done by providing that the lessee will bear the exact costs of the change in value of the vehicle that results during the lease term from his caring or failing to care for it.

S.1161 provides the same rules as provided by section 210 the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), except for two modifications:

(1) The general rule provided by the bill can be terminated or modified only by Congress.

(2) The general rule is extended to property leased for personal use.

Enactment of this bill will settle a controversy that many Senators thought should never have arisen and that was thought to have been settled by section 210 of TEFRA. Section 210 permitted the general rule to be terminated either by further act of Congress or by the publication of a regulation providing that any agreement with a TRAC clause is not a lease. However, the legislative history makes clear that Congressional sponsors of section 210 expected this regulatory power to be exercised only under extraordinary circumstances and then only after completion of tax policy and economic impact studies.

With great haste and without the economic or other studies contemplated by sponsoring Members of Congress, a regulation labeled "interpretative" was proposed less than 3 months after the enactment of TEFRA. No Regulatory Impact Analysis required by Presidential Executive Order 12291 was made on the alleged ground that the proposed rule is not a major rule. No Regulatory Flexibility Analysis was made on the alleged ground that the proposed rules are interpretative.

The bill is revenue neutral.

The need for S.1161 arises from efforts the IRS recently has made to change the traditional federal tax treatment of TRAC leases both as to commerical TRAC leases to business users and as to consumer TRAC leases to personal users. The treatment traditionally accorded such leases for over 30 years, both by lessors and by the IRS on audit of their tax returns, was to treat the lessor as the owner of the vehicle and as the party entitled to depreciation and other capital cost recovery tax allowances. The change sought by the IRS would treat the lessee instead of the lessor as the owner and deny capital cost recovery tax allowances to the lessor, shifting them instead to the lessee if he is a business user.

The IRS has attempted to make this change not by seeking Congressional enactment of a change in the law, but by administrative actions alone. Initially the IRS attempted to impose this change both retroactively and prospectively by disallowing capital cost recovery tax allowances on its audit of lessors' tax returns, and in pursuit of the audit tax deficiencies in litigation in the courts. However, since the enactment in 1982 of section 210 of TEFRA, it has sought to accomplish that result prospectively as to commercial leases through a regulation it proposed in November 1982, just 81 days after Congressional enactment of section 210 expressing a contrary policy view, and it is still seeking to accomplish that result retroactively as to consumer leases through audits and litigation.

The basic purpose of S.1161 is to permit continuation of the traditional tax treatment of TRAC leases--which is to disregard the presence of a TRAC clause in determining whether to respect a lease as such for tax purposes--unless and until

Congress enacts a further law providing that an agreement with a TRAC clause is not a lease. S.1161 would permit continuation of such traditional tax treatment in the case of commercial leases for business use and consumer leases for personal use, whether entered into before or after its enactment. Enactment of S.1161 would have the effect of requiring the IRS and the Treasury to persuade Congress that it would be good tax policy and good economic policy to change the traditional tax treatment of TRAC leases as true leases for federal tax purposes.

Enactment of S.1161 is necessary to prevent the Internal Revenue Service from continuing a course of action that would force motor vehicle lessors to change the efficient way they have been doing business for over 30 years, and in the process cause substantial injury to U.S. motor vehicle lessors, dealers, manufacturers, workers and users, without providing any significant benefit to Treasury and the public. Enactment of S.1161 will also prevent the IRS from continuing a course of action that is contrary to the intent of Congress, and will place the policy decision that would be involved in forcing a change of 30 years of efficient business practice where that decision belongs -- with Congress.

Lessees should not be forced to change 30 years of efficient business practice to a less efficient practice that will harm all segments of the motor vehicle industry, its workers, and motor vehicle users.

Motor vehicle lessors should not be forced to change their business practice. The TRAC lease was developed over 30 years ago to meet the needs of business. Today it is a business practice that accounts for upwards of 16% of Detroit's annual output. It is a business practice that today accounts for nearly 70% of all motor vehicle leases. Motor vehicle TRAC leases have achieved this widespread use and importance because they constitute the most efficient form of motor vehicle lease transaction. They are efficient because they ensure that the party best able to care for and maintain the vehicle -- the lessee -- will bear the full cost of use and possible abuse of the vehicle. Vehicle condition, appearance and extent of use are the factors that are most important in determining the resale value of an automobile.

Any other form of motor vehicle lease transaction will be less efficient and more expensive. "Wear-and-tear" clauses typically found in closed-end motor vehicle leases are not satisfactory substitutes for TRAC leases. They inevitably lead to costly and unpleasant disputes between lessors and lessees. These leases are also generally more expensive because the lessor must charge more rent to protect against the possibility of inadequate maintenance, excessive mileage, or a more demanding use of the vehicle than was anticipated at the inception of the lease.

A needless requirement to change current business practice will be costly to everyone involved. Initially, there will be a substantial disruption as business reevaluates its available options. During this period, there will be a substantial reduction in the number of new leases and vehicle deliveries. We anticipate this period will last at least three months and maybe as long as nine months. A three-month delay in vehicle replacements could mean 325,000 less new car purchases with a sales value of $3.7 billion. This is a loss that would never be recouped by lessors, dealers, and manufacturers.

After the initial period of disruption, less efficient and more expensive forms of leases will mean higher prices to users for the same vehicles, less business for motor vehicle lessors, dealers and manufacturers, and less jobs for workers. To the extent that business users would choose to own vehicles rather than continue leasing, the loss to the U.S. motor vehicle industry and its workers will be even greater. The loss that would be incurred by lessors is obvious. The loss that would be incurred by U.S. manufacturers and workers is perhaps less obvious, but nevertheless real. Nearly all vehicles used in commercial fleet leases are U.S. manufactured. This represents a sharp contrast to the percentage of user-owned vehicles that are U.S. manufactured. Industry studies also indicate that the average holding period for leased business vehicles is 28 months, compared to 32 months for user-owned vehicles. A four-month extension in the holding period of vehicles currently leased by business under TRAC leases would translate into a loss every year of 200,000 vehicle purchases worth $2 billion.

Thus, a requirement to change business practice will have serious adverse consequences not only to lessors and dealers, but to U.S. manufacturers and workers as well. But the harm that would be inflicted on U.S. motor vehicle lessors, dealers, manufacturers, workers and users is unnecessary. There is, in fact, no business, economic or tax policy reason to require motor vehicle lessors to change the efficient way they have done business for more than 30 years. Moreover, the burden should not be on motor vehicle lessors to justify the way they have done business for more than 30 years. The burden should be on the IRS to justify the hardship that would be caused by its proposal.

We understand the need for the IRS to be vigilant against transactions that are mere tax avoidance devices. Motor vehicle TRAC leases do not fit that mold. Indeed, most motor vehicle leases are not even tax motivated. Motor vehicle leasing companies expect to realize an economic profit from the leasing transactions which, for many such companies, is their principal source of income. The users typically choose to lease instead of own vehicles for sound business reasons unrelated to tax avoidance, such as: (1) the use of "off-balance sheet financing" which enables businesses to use late model vehicles without impairing their financial statements, (2) avoidance of a large initial down payment thereby conserving working capital, (3) the ability to use late model vehicles without violating potential restrictions on borrowings or regulatory agreements, and (4) the ability to have use of late model vehicles without being subject to onerous federal, state and local law requirements relating to motor vehicle ownership. In short, TRAC leases are business transactions entered into to benefit both parties to the transaction on a business and economic basis, and there is no tax policy reason which we can discern that would justify changing 30 years of efficient business practice.

Anticipated revenue effect if the IRS were allowed to force a change in existing business practice.

Economic consultants to the ad hoc group, Emil M. Sunley and Gerard M. Brannon, have concluded that S.1161 is essentially revenue neutral, and on balance would likely produce a small revenue gain. If the IRS were allowed to pursue a course of action to change existing law, the reaction among motor vehicle lessors and users would likely vary. As previously stated, there will be a period of initial disruption during which business evaluates available alternatives, reexamines existing motor vehicle lease agreements, and the like. During this period, the replacement of vehicles currently leased by business may come to a virtual halt. Economic consultants to the ad hoc group estimate that a three-month delay in vehicle replacement would reduce federal revenues by $900 million. In the long term, several alternative forms of motor vehicle transaction may be used: (1) businesses may continue to lease automobiles under a different form of lease such as a "closed-end" lease; (2) businesses may purchase automobiles outright; or (3) TRAC leases may continue to be used with an upward adjustment of rent to reflect conditional sale treatment for tax purposes under which the user would be allowed the cost recovery allowances and investment tax credits. Of course, a combination of these alternatives is also possible. No one at this time can predict how the motor vehicle leasing industry and motor vehicle users would adapt if the IRS were allowed to continue its attempt to change existing law. It is predictable that in those few cases where the lessee could not use the cost recovery allowances and investment tax credits, the lease will be structured in a way that will satisfy IRS guidelines. Economic consultants to the ad hoc group have estimated that if all business lessees (other than those few business lessees who would be unable to use ACRS allowances and investment tax credits) were to continue use of TRAC leases that were treated as conditional sales agreements for tax purposes, the government would actually lose $85 million in tax revenue annually. The economic and revenue impact of S.1161 is discussed in greater detail in separate statements submitted by Gerard M. Brannon and Emil M. Sunley.

Enactment of S.1161 will prevent the IRS from continuing a course of action that is contrary to the intent of Congress.

There is overwhelming evidence that the principal sponsors of legislation that ultimately was enacted as section 210 of TEFRA did not intend for Treasury to exercise an unfettered discretion in publishing a regulation to reverse the rule of section 210. Statements made for the record by principal sponsors of the legislation, such as Senator Bentsen, made it very clear that Congress did not expect the rule of section 210 to be reversed except in "extraordinary circumstances" and then only after Treasury had conducted policy-level studies showing a clear need for such a regulation. The IRS, in complete disregard of the intent of Congress, turned right around and published a proposed regulation to reverse section 210 less than three months after it was enacted. Of course, no policy-level studies were conducted by Treasury. Equally alarming is the failure of the IRS to comply with other procedural regulatory requirements, such as the preparation of a Regulatory Impact Analysis as required by Executive Order 12291 and a Regulatory Flexibility Analysis as required by the

Regulatory Flexibility Act. The IRS determined that it was not subject to these requirements imposed on other agencies by the self-proclamation that the proposed regulation is not a "major rule" (in disregard of the substantial damage that the regulation would cause to the motor vehicle industry, workers, and consumers) and that the proposed rules are merely "interpretative" (in disregard of the fact that the proposed regulation would reverse a statutory rule rather than interpret it). In view of the IRS' history on this matter, the legislative authority delegated to it in section 210 should be removed by Congress as quickly as possible.

As a matter of fairness and policy, consumer leases of motor vehicles for personal use are entitled to the same protection as is presently afforded to motor vehicle business leases by section 210 of TEFRA.

S.1161 appropriately extends the protection presently afforded to motor vehicle business leases by section 210 of TEFRA to consumer leases of motor vehicles for personal use. There is no conceptual or policy difference between business leases and consumer leases. Furthermore, consumer leases are equally entitled to protection against an IRS change in audit position as are business leases.

The exclusion of consumer leases of motor vehicles from section 210 of TEFRA was done at the request of Treasury at the last moment during the Senate Finance Committee mark-up proceeding. The type of use by the lessee was not relevant in the proposal initially sought by the principal sponsors of the legislation, Senators Bentsen and Armstrong, nor in any of the other earlier legislative proposals on this subject. The Treasury request for the unusual limitation was probably prompted by an initial fear of a potential revenue loss, although no detailed revenue estimate had been prepared on that aspect of the legislation. As explained in the Congressional Record in an exchange of correspondence between Senator Bentsen and Congressman Matsui, 128 Cong. Rec. E3867 (dailey ed., August 12, 1981), no negative inference was intended by the omission of consumer leases in section 210 of TEFRA. Economic consultants to the ad hoc group have concluded that extension of the rule set forth in section 210 of TEFRA to consumer leases should not result in a revenue loss, as discussed in detail in their statements submitted on S.1161.

Appropriate consideration was not given to the tax policy or revenue implications of the personal use limitations in section 210 of TEFRA. Adoption of such an unusual rule distinguishing the lessor's tax treatment based on the type of use by the lessee should be made only by Congress after appropriate consideration of the tax policy and economic implications. As a matter of law and sound tax policy, there is no reasonable basis for distinguishing the lessor's tax treatment in motor vehicle transactions on the basis of how the lessee uses the property. Such a distinction would not only be unsound tax policy and law, but would create unnecessary compliance and administrative difficulties for taxpayers and the IRS.

Consumer leases are also entitled to the same protection against the retroactive application of an adverse change in longstanding IRS audit policy as are business leases. One of the purposes of section 210 of TEFRA was to prevent retroactive application of a new IRS audit policy. Before the change in IRS audit policy as reflected in a 1979 Technical Advice Memorandum, the longstanding IRS audit position was to recognize TRAC leases as true leases. Leslie Leasing Co., 80 T.C. ____, No. 15 (1983). This longstanding audit position was the same for business leases and consumer leases. Consumer leases are entitled to the same protection against retroactive changes in IRS audit position as is afforded by section 210 of TEFRA to business leases. Consumer leases are also entitled to protection against future administrative attempts to change the law that are undertaken without appropriate policy and economic considerations.

Technical Legal Considerations

We have been told that the purpose of the IRS in pursuing its position on motor vehicle TRAC leases is to achieve what some regard as "technical purity." Even if technical purity were achieved, that is not sufficient reason to require lessors to change over 30 years of business practice with the resulting disruption and economic harm that would occur. While I am not a lawyer, and a detailed technical discussion of the law is beyond the scope of this statement, it is apparent that the proposed regulation is not as technically pure as the IRS would like one to believe. The position advocated by the IRS is based on the premise that a shifting of substantial risk to the property user causes the user to be treated as owner of the property. Application of such a test, which was rejected by the U.S. Supreme Court in Frank Lyon Co. v. U.S., 435 U.S. 561 (1978), leaves businessmen such as myself (as well as our counsel) wondering whether any leases would be treated as such for tax purposes. Any lessor in the business of leasing must shift risk to the lessee in one form or another if it is to remain in business. For example, so-called closed-end motor vehicle leases typically contain wear-and-tear clauses to shift substantial risks to the lessee. TRAC leases were developed as a more efficient substitute for the problems inherent in closed-end leases with wear-and-tear clauses. One is simply left wondering what type of lease could qualify under the test advocated by the IRS. Furthermore, we can only ask why the U.S. Tax Court, a court with special expertise in tax matters that hears only tax cases, failed to appreciate the technical merits of the IRS position and flatly rejected it. A more detailed analysis of the legal considerations is contained in a Memorandum of Law in support of S.1161 prepared by Piper & Marbury, counsel to the ad hoc group, which will be submitted for inclusion in the printed record of the hearing.

Conclusion

S.1161 would prevent the IRS from pursuing a course of action that would force motor vehicle lessors to needlessly change the efficient way they have been doing business for over 30 years. It would prevent the IRS from pursuing a course of action that will inevitably cause substantial injury to U.S. motor vehicle lessors, dealers, manufacturers, workers, and users without providing any corresponding benefit to Treasury and the public. S.1161 would also prevent the IRS from continuing a course of action that is contrary to the intent of Congress. It will place the policy decision that would be involved in forcing a change in 30 years of efficient business practice exclusively with Congress where that decision belongs. We urge prompt enactment of S.1161.

STATEMENT OF JOHN F. CARTWRIGHT, FORD MOTOR CO., DEARBORN, MICH., ON BEHALF OF MOTOR VEHICLE MANUFACTURERS ASSOCIATION

Mr. **Cartwright**. My name is John Cartwright. I am appearing on behalf of the Motor Vehicle Manufacturers Association of the United States.

We urge the immediate enactment of S. 1161 to prevent the IRS from asserting its regulatory power to change the existing law respecting open-end leasing. There are in excess of 3 million motor vehicles on lease throughout the United States, of which approximately 69 percent are open-end leases containing a "terminal rental adjustment clause" commonly referred to as TRAC.

The open-end lease is not a tax oriented document, as suggested by the Treasury. It has existed for approximately 30 years; was in existence before there were any tax benefits arising from it; and it is surely not a safe harbor lease, as indicated by the Treasury representative. It must be a true lease, notwithstanding the fact that there is a TRAC clause involved, whereas, under safe harbor, any document could have been called a lease. It evolved in an intensely competitive industry in order to produce the lowest rental payment for the lessee by giving the lessee the benefit of a lower rental rate by virtue of making him responsible for the condition of the product at the end of the lease term.

The TRAC clause, in essence, provides that at termination of the lease when the lessor sells the vehicle if the proceeds exceed the projected residual value agreed upon by the parties at the commencement of the lease, then the lessee receives a refund. If, on the other hand, the proceeds are less than the residual value, the lessee must pay additional rent. This is a method of sharing the risk between the lessor and the lessee and spreading the risk based on the value of the vehicle at the end of the lease by virtue of how good a care the lessee takes of the vehicle.

The proposed regulations would eliminate the TRAC and would result in only the closed end lease being recognized for tax purposes. This would result in substantial increases in rental rates and threaten the survival of the leasing industry as we know it today. The larger leasing companies would be reluctant to do business in an atmosphere in which they are solely responsible for the entire loss on resale at the end of the lease because of the thousands of vehicles they own and lease. The smaller and weaker leasing firms could not accept the risk due to the restrictions and limitations placed upon them by the financial sources. The rental rates would necessarily be higher for the closed end lease to compensate the lessor for the additional risk he must take with respect to resale, and because of the higher interest rates charged by the financing sources.

Failure to enact S. 1161, with a corresponding promulgation of the proposed regulation, would be disruptive to an established system of orderly distribution. It would surely cause delays in ordering of vehicles by the fleet lessees while they determine the best economics of either to buy or lease.

A study prepared for the American Automotive Leasing Association indicates that the holding period for fleets that own their vehicles exceeds that for fleets which are leased by approximately 4 months, and that for each month of delay, it would result in 49,000 lost vehicle orders. A 4-month delay resulting from the uncertainty of the tax law could therefore result in lost sales by the manufacturers of some 200,000 units a year, which, of course, would result in consequent production losses as well as additional unemployment at both the manufacturer and at the dealer level.

The proposed regulations are contrary to the congressional intent of section 210 of TEFRA as was reflected in the correspondence between Congressman Matsui and Senator Bentsen appearing in the August 12, 1982 Congressional Record in which Senator Bentsen, in urging the support of his colleagues, indicated "that a change was to be affected by Treasury regulations only in the most extraordinary circumstances."

In its haste to unilaterally change the law, the IRS abrogated this intent of Congress, and also the congressional and Presidentially prescribed standards for promulgating new administrative rules. It disregarded the requirements of the Regulatory Flexibility Act of 1980 and its mandate for regulatory flexibility analysis. It also abrogated the requirements of Executive Order 12291 and its requirement for a Regulatory Impact Analysis. Moreover, the Executive order provides that rulemaking action cannot be undertaken unless the potential benefits to society for the regulation outweigh the potential cost to society. The proposed regulations would increase the rental to the consumer and provide no additional revenue to the Government, because the business lessee would receive the benefit of the ITC and ACRS. In fact, the proposed regulations would more likely cause a loss of revenue to the Government because the tax basis for ITC and ACRS would be higher in the hands of the lessee than the cost basis to the lessor, who would otherwise obtain the benefit.

Prompt enactment of S. 1161 is required in this session of Congress to eliminate the unfavorable impact, that the uncertainty of the tax law may have on the leasing industry and its consequent effect on sales of motor vehicles by the U.S. manufacturers to this important segment of its business. Thank you.

Senator DURENBERGER. Thank you, Mr. Cartwright.

[The prepared statement of Mr. Cartwright follows:]

STATEMENT OF JOHN F. CARTWRIGHT

ON BEHALF OF

MOTOR VEHICLE MANUFACTURERS ASSOCIATION
OF THE UNITED STATES

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE FINANCE COMMITTEE

JUNE 7, 1983

Re: S.1161---Amend the Internal Revenue Code of 1954 to Treat Certain Motor Vehicle Operating Leases as Leases for Federal Income Tax Purposes

Mr. Chairman, members of the Subcommittee:

My name is John F. Cartwright and I am testifying on behalf of the Motor Vehicle Manufacturers Association of the United States, Inc. and its constituent members,* who enthusiastically support S-1161.

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* MVMA represents U.S. automobile, truck, and bus manufacturers producing more than 99 percent of all domestic motor vehicles. MVMA members include: American Motors Corporation; Chrysler Corporation; Ford Motor Company; General Motors Corporation; International Harvester Company; M.A.N. Truck & Bus Corporation; PACCAR Inc; Volkswagen of America, Inc.; and Volvo North America Corporation.

S-1161 will prevent the Internal Revenue Service through its regulatory power from changing the long standing tax treatment of "open-end" vehicle leases which have been used in the great majority of instances for the past 30 years throughout the automobile and truck leasing industry.

Even with the current depressed market which has existed for the last several years it is estimated that substantially in excess of two million[1] cars and trucks are currently under lease and that approximately 69%[2] of these leases are "open-end" leases which contain a "terminal rental adjustment clause" commonly referred to as a TRAC.

(1) Development of Open-End Lease and Its Cost Effectiveness

The open-end lease transaction, which is now threatened as a method of conducting business by the Service's proposed Regulation Section 1.168(f)(8)-12 [issued pursuant to Section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)] was developed in an intensely competitive industry in order to produce lower rental payments and give the lessee an incentive to maintain the lease vehicle in good condition. The TRAC provides that upon termination of the lease, the vehicle will be sold by the lessor and, if the proceeds from sale are less than the projected residual value established by the lessee and lessor upon execution of the agreement, the lessee is obligated to pay additional rent, but, if the sales proceeds exceed the residual value, the lessee receives a refund of rent. There is no option by the lessee to purchase. The open-end lease was developed in a market place involving extreme competition and enables the lessor to charge rents less than what otherwise would be required under a closed-end lease where the lessor must accept the entire burden for the value of the vehicle upon termination of the lease except for apparent body damage and excess mileage. The open-end lease has also virtually eliminated the controversy which otherwise arose between the lessor and lessee as a result of the squabble over the cost to fix body damage or excess wear and mileage.

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[1] See Senate Report No. 94-590 pertaining to the Consumer Leasing Act of 1976 in which the Senate Report under the subtitle "Need for the Legislation" stated that "as of 1974, 2.8 million, about 26% of the total number of cars made, were leased, and 36% of this total was leased to individuals."

[2] Runzheimer and Company, Inc., Rochester, Wisconsin, reported in its "1980 Survey and Analysis of Business Car Policies and Costs" (p. E-10) that approximately 69% of automobile leases were rent adjustment leases. The statistics from the Runzheimer survey are set forth in a consulting economist's study prepared by Robert R. Nathan Associates, Inc., in connection with the consideration of the investment tax credit provision of the Economic Recovery Act of 1981 on pages 82-86.

The enactment of S-1161 would remove the threat of the proposed Regulation to the survival of the leasing industry and continue to provide lower leasing costs to the consumer. Because the proposed regulations would require removal of the TRAC provision from an agreement in order to create a lease which is recognized for tax purposes, all leases would be "closed-end" and would place the full risk for the residual value of the vehicle on the lessor. Larger leasing companies would be reluctant to do business in an atmosphere in which they must accept the potential risk of the entire loss on resale at less than an anticipated projected residual value in view of the thousands of units they own and lease to the large fleet operations. The smaller or weaker leasing firms could not accept this risk due to the restrictions and limitations which would be imposed by their financing sources, forcing many of the leasing firms out of business. If lessors offered only closed-end leases, the cost of leasing to the consumer would rise considerably since rental payments on closed-end leases are necessarily higher than those under open-end leases in order to compensate the lessor for assuming the full risk of loss that may be incurred upon sale of the vehicle at lease termination.

(2) Benefits to Economy from not Changing Automotive Leasing Methods

The failure to enact S-1161 with the corresponding promulgation of the proposed Regulations (Reg. Section 1.168(f)(8)-12) by the Treasury would have a disruptive effect on an established system of orderly distribution of automobiles and trucks through the fleet leasing network. It undoubtedly would wreak havoc with industry lease transactions and many fleet lessees would purchase their vehicles because of the increased cost of leasing which results from the closed-end lease and the uncertainty of the tax consequences. There is no question that delays in ordering new vehicles would occur while the management of fleet leasing customers determine the best economics of either to buy or lease.

Such delays would cause substantial economic hardship since a statistical study prepared for the American Automotive Leasing Association by Robert R. Nathan Associates, Inc. in 1981, *The Effectiveness of the Accelerated Cost Recovery System and Alternative Tax Incentives in Inducing Investment in Short Term Assets*, indicates that the average vehicle use time for fleet users who own their own business fleets was approximately 32 months compared to the average vehicle use time of 28 months for fleet users who leased their business fleets. The study also indicated that for every month the holding period increased for business vehicles it resulted in 49,000 lost sales each year. A three or four month loss of sales at the magnitude of 200,000 vehicles is very significant and would result in production cutbacks by the manufacturers as well as higher unemployment at the manufacturers and dealerships.

(3) Proposed Regulations are Contrary to Congressional Intent of Section 210 of TEFRA

The "Confirmation of Congressional Intent" for Section 210 of TEFRA was set forth in the Congressional Record, dated August 12, 1982 (Vol. 128, E 3869) pursuant to an exchange of correspondence between Congressman Matsui of California and Senator Bentsen. In urging the support of his colleagues, Senator Bentsen, in his letter referring to himself and Senator Armstrong, made it clear that a change should be effected by prospective Treasury Department regulations only in the most extraordinary circumstances. In its haste to change the law unilaterally, the Internal Revenue Service has not only abrogated the intent of Congress as expressed by Senator Bentsen but has also violated Congressional and Presidentially prescribed procedural standards for promulgating new administrative rules.

The Service perfunctorily concluded that its proposed regulations are merely interpretive and that the small business protective requirements of the Regulatory Flexibility Act of 1980 and its mandate for a Regulatory Flexibility Analysis were not required. The error of this conclusion is demonstrated by the fact that the current law as set forth in Section 210(a) of TEFRA provides that the existence of a terminal rental adjustment clause shall not be taken into account in determining whether such an agreement is a lease. The intent of Congress as previously stated, indicates that change would be effected by prospective regulations only in the most extraordinary circumstances. Indeed, Section 210 of TEFRA places no obligation or requirement on the Commissioner to issue the proposed regulations which would change the law.

Section 210(b) of TEFRA by its specific language provides that the current status of the law as set forth in Section 210(a) cannot be changed unless Congress makes a "legislative" or "substantive" change by enacting legislation or the Treasury publishes regulations. It, therefore, is completely irrational and irresponsible to contend that Congress did not also intend that any change in the law by the Treasury was anything less than "substantive" or "legislative" in nature, if Congress could only make such a change by legislation.

The Service also dogmatically determined that the proposed regulations did not constitute a "major rule" under Executive Order 12291 and that preparation and consideration of a Regulatory Impact Analysis was therefore not required. If any analysis had been conducted by the Service, it would have become obvious that implementation of the proposed regulations would have an economic effect which would meet each of the definitional criteria for a major rule. For example, if you assume under the most conservative approach that the lessor would only increase the rental charge by the amount of the ITC benefit it lost, then the cost to the lessee would increase by $540 per unit based on the average cost of leased vehicles for 1982 of approximately $9,000. Using this conservative approach, it would only require that 185,186 lease units be placed in service to reach an annual impact on the economy of $100 million or more. This alone would cause the regulation to constitute a "major rule" under Section 1(b) of the Order considering the fact that far in excess of a million vehicles are currently being leased for business purposes pursuant to agreements containing a TRAC.

Section 2(b) of the Executive Order directs that rulemaking action cannot be undertaken unless the potential benefits to society for the regulations outweigh the potential costs to society. The proposed regulations would provide no additional revenue to the Government since the business lessee would be entitled to the ITC and ACRS. In fact, the proposed regulations would more than likely result in a revenue loss to the Government because the tax basis for the ITC and ACRS in the hands of the business lessee will be higher than the cost basis of a lessor who would have claimed the ITC and ACRS but for the proposed regulations. The increased rental to the lessee which will undoubtedly be charged by the lessor far outweighs any conceivable benefit to society, if any, resulting from the regulations.

It is most important that S-1161 be enacted this year if we are to preclude the adverse effect of the proposed regulations which the Internal Revenue Service appears to be dedicated to promulgating in final form. Prompt enactment also is needed to eliminate the unfavorable economic impact that the uncertainty of the tax law may have on the motor vehicle leasing industry and its consequent effect on sales of motor vehicles to this important segment by the U.S. domestic automobile manufacturers. The Motor Vehicle Manufacturers Association urges your early enactment of S-1161.

Thank you.

SUMMARY OF STATEMENT BY JOHN F. CARTWRIGHT
ON BEHALF OF THE MOTOR VEHICLE MANUFACTURERS ASSOCIATION OF THE UNITED STATES
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
ON S-1161

I. Enactment of S-1161 Required to Prevent IRS from Asserting Its Regulatory Power to Change the Existing Tax Law Respecting Open-end Motor Vehicle Leases.

  A. Magnitude of the effect of the legislation.

II. Development of the Open-End Lease and its Cost Effectiveness

  A. Aspects of open-end lease and its saving to lessee.

  B. Proposed regulations would eliminate TRAC and result in only closed-end leases recognized as leases for tax purposes which would cause higher rental rates.

III. Benefits to Economy from not Changing Automotive Leasing Methods

  A. Change would have disruptive effect on an established system of orderly distribution.

  B. Change would cause delays in ordering by fleet lessees.

    1. Result in sales loss of 49,000 vehicles per month of delay.

    2. Result in production cutback and further unemployment.

IV. Proposed Regulations are Contrary to Congressional Intent of Section 210 of TEFRA

  A. Congressional record indicates change was to be effected by Treasury regulations only in the most extraordinary circumstances.

  B. In haste to unilaterally change law, IRS violated Congressional and Presidentially prescribed standards for promulgating new administrative rules.

    1. Disregard of Regulatory and Flexibility Act of 1980 and its mandate for a Regulatory Flexibility Analysis.

    2. Disregard of Executive Order 12291 and the preparation of a Regulatory Impact Analysis.

    3. Benefits to society from regulations do not outweigh cost to society.

STATEMENT OF GEORGE F. WEIMER, DIRECTOR OF TRANSPORTATION SERVICES, CONTINENTAL TELECOM INC., ATLANTA, GA.

Mr. **Weimer**. Good morning. My name is George Weimer. I am director of transportation services for Continental Telecom Inc. I have been actively involved in the motor vehicle leasing business for over 26 years in positions both with lessors and lessees. I am here today testifying in favor of 1161 on behalf of Continental Telecom.

Based on my experience in the industry, it is my opinion that many of the reasons for Continental Telecom's support of this bill are common to most commercial lessees.

Continental Telecom is headquartered in Atlanta, Ga. It is the third largest independent telephone company in the United States. We provide telephone service to over 2 million customers residing in rural and isolated areas in over half the States in the United States. In order to meet the expanding communication needs of our customers, the operating telephone companies, which are part of Continental Telecom, utilize over 7,000 vehicles. Most of these vehicles are leased by Continental under agreements which contain TRAC clauses. We have selected this form of transaction since it is our business judgment that TRAC leases provide Continental with a means of providing our operating companies with motor vehicles at the lowest net cost, while at the same time providing flexibility in our original vehicle selection and replacement.

A company's decision to lease vehicles is motivated by the services provided by lessors relating to the acquisition and disposal of vehicles, handling of State titling and registration arrangements, filing and paying of State/county municipal taxes, vehicle specification assistance and similar services. The use of leased vehicles makes additional capital available which Continental uses to improve services to our customers.

A TRAC lease, as opposed to other forms of leases, such as so-called closed end leases, provides Continental and other lessees with the flexibility of lease terms needed to efficiently and safely operate large motor vehicle fleets.

Transportation managers need to be able to replace vehicles when we determine that the cost of maintaining the vehicle becomes excessive. Such decisions must be made on a vehicle by vehicle basis, and often has no relationship to when the vehicle was placed in service. So-called closed-end leases are both more expensive than TRAC leases and contain provisions which impose substantial penalties for removing a vehicle from service prematurely. TRAC leases provide the flexibility to replace vehicles prematurely with more fuel efficient vehicles. Increasing of fleets' miles per gallon is a goal which not only makes good business sense, but is beneficial to the interest of the Nation.

We estimate that due to the vehicles we replaced last year alone, Continental will save over 3 million gallon of fuel annually. It should be emphasize that most commercial lessees have adopted vehicle maintenance programs to promote the public image of the company and to provide safety for its employees. I can assure you that large sums of money are spent each year by lessees on vehicle maintenance. The TRAC lease, as opposed to a closed-end lease, or other lease forms, is the only device which enables a lessee to be compensated for the increased market value of a vehicle attributable in a substantial part to the maintenance dollars spent by such lessees.

In order to preserve this cost-effective method of obtaining the use of motor vehicles, I urge each member of this subcommittee to work for the enactment of S. 1161. Thank you very much.

Senator **Durenberger**. So do I, Mr. Weimer. Thank you very much.

Our next witness, or witnesses, will be Dr. Brannon and Dr. Sunley. And if Dale Wickham wants to add anything under this portion of our testimony, feel free to do so.

Dr. Brannon.

[The prepared statement of Mr. Weimer follows:]

Statement of George E. Weimer
Director Of Transportation Services
Continental Telecom Inc.
Before the Committee on Finance,
Subcommittee on Taxation and Debt Management
at June 7, 1983 Public Hearing on S.1161

Mr. Chairman, members of the Committee, I am George E. Weimer, Director of Transportation Services, Continental Telecom Inc., and thank you for the opportunity to testify today in support of S.1161.

I have been actively involved in the motor vehicle leasing industry for over twenty-six years. I began my career with the Hertz Corporation in 1957 and held several positions in that company before leaving in 1973. At the time of my departure from Hertz, I was Vice President of Sales for the Car Leasing Division. I joined Continental Telecom Inc. in 1973 as its Director of Transportation Services and as President of Medusa Leasing Co., a wholly-owned leasing subsidiary of Continental Telecom.

Continental Telecom Inc. is headquartered in Atlanta, Georgia. It currently operates telephone companies in thirty-six states and is the third largest independent telephone company in the United States. The overwhelming majority of Continental's two million plus customers reside in rural or isolated regions. Increasing the quality of telephone communication services to these customers is Continental's primary objective. Due to the distances involved in the areas we serve, the efficient use of motor vehicles is essential to expanding and maintaining our commitments to our customers. At the present time, the operating telephone companies which are a part of Continental Telecom utilize over 7,000 vehicles. All of these vehicles are leased under agreements containing TRAC clauses.

I am here today to urge each member of this Subcommittee to work for the enactment of S.1161. Based on my years of experience in the industry, it is my opinion that many of the reasons for Continental Telecom's support of this bill are common to most commercial lessees.

Vehicle Acquisition and Disposal

The motor vehicle leasing business is primarily a service business. A significant service provided to commercial lessees by lessors is assistance in assessing the lessee's vehicle needs and matching available equipment to meet these needs. This service removes from the lessee the burden of negotiating a favorable price for the acquisition of the vehicle and making arrangements for its delivery. For corporations operating throughout the United States, such services are particularly valuable. At the end of the lease term, the lessor has the responsibility to sell the vehicle at the most favorable price. Finding purchasers for the used vehicles and consummating such sales is becoming increasingly difficult due to rapid changes in the markets for such commodities. Most companies simply aren't equipped to stay abreast of these market changes. It needs to be emphasized that commercial lessees typically don't want to buy the vehicles at the end of the lease term. The vehicle has served its usefulness to us and needs to be replaced.

Compliance with State and Local Government Statutes and Regulations

Motor vehicle lessors, as the owners of the vehicles, are responsible for compliance with all state, county and municipal laws relating to the titling and registration of the vehicles leased to companies such as Continental Telecom. It is the responsibility of the motor vehicle lessors to file returns and pay all taxes relating to the leased motor vehicles. Lessors are also the recipients of unpaid parking tickets and similar fines from literally every law enforcement agency in the country! As the members of this Subcommittee can well appreciate, all of these matters must be handled on an expeditious basis or the vehicle may not be permitted to operate in the local jurisdiction. I can assure you that administering this area creates one large headache which the typical lessee is ill-equipped to cure and is grateful to have handled by the lessor.

Financing Vehicle Acquisitions

The use of leasing enables companies to acquire the use of vehicles without becoming involved in the financial arrangements required to purchase the vehicles. The vehicles in commercial fleets typically have service lives which are shorter than the length of investments favored by most commercial lenders. The motor vehicle lessors are totally responsible for the repayment of this debt, with the result that funds available to the lessee company from outside lenders can be utilized by the company in other areas of its business. This is a principal reason for Continental's decision to lease motor vehicles since it has enabled us to enhance the quality of service to our customers which we simply couldn't have accomplished if funds would have had to be utilized to purchase vehicles.

Flexibility of TRAC Leases

TRAC leases provide lessees such as Continental with greater flexibility in the management of their business fleets as compared with the so called "closed end" and other forms of lease.

Since closed end lessors are looking to the resale value of vehicles as a source of profit as opposed to the periodic rent payments, they often restrict the makes and models of vehicles which they will lease. Closed end lessors desire to lease only "standard equipped" makes and models which are potentially more readily saleable at more predictable prices than other vehicle types. Such restrictions, which are not imposed by TRAC lessors, would be totally unacceptable to Continental based on the variances in terrain and climatic conditions in which our vehicles operate.

TRAC leases also provide lessees with flexibility as to the duration of our leases in order that the vehicles can be operated as efficiently as possible. Transportation managers need to be able to replace vehicles when it is determined that the maintenance costs of such vehicles are excessive. Notwithstanding recent improvements in vehicle quality control by the domestic manufacturers and their increased emphasis on robotics, occasionally a vehicle comes off the production line which very quickly develops maintenance problems. Maintenance problems often have no relationship to when the vehicle was placed in service but depend on other factors such as operator use, mileage, road conditions, etc. Decisions on replacements must be made on an individual vehicle by vehicle basis when the transportation manager detects that a vehicle may have a potential maintenance problem. Closed end leases typically contain provisions which impose substantial penalties for removing a vehicle from service prematurely or at other than predetermined intervals which preclude such replacement decisions.

Restrictions on a lessee's ability to replace vehicles also thwart efforts by vehicle lessees to increase the fuel efficiency of their fleet. As I'm certain each member of this Subcommittee would agree, increasing a fleet's miles per gallon average not only makes good business sense, but is beneficial to the interests of the nation. I am proud to report that based upon an ability to make timely, unrestricted vehicle replacements last year under our TRAC lease, Continental Telecom expects to reduce the annual fuel consumption of its corporate fleet by more than three million gallons!

TRAC Leases Provide The Lowest Net Cost Lease Transaction

Throughout history lessees have been charged rent for the use of property. TRAC clauses provide a mechanism to enable motor vehicle lessees to achieve this historic economic result in the most efficient way possible. The efficiencies in these transactions result since rentals are determined based on known rather than estimated costs. Under a TRAC lease a lessor develops its rental based upon its known costs and desired profit expectation. If the targeted resale value of the vehicle proves to be incorrect, a retroactive rent adjustment is made, based upon the actual resale proceeds from the vehicle. The lessor in a closed end lease must always include in its determination of rent a resale value less than what it anticipates will be the future resale value of the vehicle. I can assure you, based upon my experience in that area of the industry, that such assumptions are very low to provide a large measure of "insurance" to the lessor. This uncertainty as to resale value equates into higher rentals under closed end leases and makes it a higher cost form of lease which I feel is unacceptable to most large commercial lessees.

It is also important to recognize that most commercial lessees have adopted periodic, comprehensive vehicle maintenance programs. To our customers, our employee and service vehicle represent Continental Telecom. Our maintenance programs are designed so that our vehicle fleet helps to promote the public image of the company while at the same time providing the safest possible vehicle for use by our employees on the highways in areas which we serve. I can assure you that responsible commercial lessees annually spend large sums of money on vehicle maintenance. The TRAC lease, as opposed to a closed end or other lease form, is the only device which enables a lessee to be compensated for the increased market value of a vehicle attributable in substantial part to the maintenance dollars spent by the lessee during the vehicle's lease term.

As stated previously, commercial lessees are looking for a lessor to provide needed services. As a practical matter, these services can only be effectively provided when the lessee and lessor are able to work together analyzing new vehicle technology, maintenance programs, vehicle replacement schedules, etc. Inherent in the structure of closed end leases are provisions which run counter to such an open relationship. Lessees typically try to spend as little as possible on maintenance since such expenditures will only benefit the lessor. The time and money spent in disputes between lessors and lessees under such arrangements concerning vehicle condition at the termination of leases are not productive for either party.

Conclusion

S.1161 prevents the IRS from imposing a change in the tax treatment of TRAC leases which would deny to American business the most efficient method of leasing motor vehicles. I know of no benefit to Continental Telecom or any other commercial lessee which would result from allowing the IRS to finalize its proposed regulation. Any alternative to the TRAC lease will result in higher costs to obtain the use of vehicles needed to supply goods and services. Such increased costs to business is not warranted especially when, as I understand economic experts have concluded, the proposed IRS change would be of no revenue benefit to the government. I urge you to enact S.1161 and to do so as promptly as possible to eliminate the economically unsettling effects of the uncertainty caused by the IRS' proposed regulation.

STATEMENT OF DR. GERARD M. BRANNON, ON BEHALF OF AD HOC TAX GROUP OF U.S. MOTOR VEHICLE LESSORS, MANUFACTURERS, WORKERS, DEALERS, AND CONSUMERS, WASHINGTON, D.C.

Dr. **Brannon.** I am Gerard Brannon. I have been retained on behalf of a number of motor vehicle lessors to provide revenue estimates and related economic analysis of changing the treatment of TRAC leases. In this project I have worked with Emil Sunley. Neither of us have a background in motor vehicle leasing. Both of us have done considerable work in general economic analysis of tax policy.

On the immediate problem of revenue estimates, we have spent considerable time looking at this issue and tracking down a great deal of trivia. It turns out there are slight effects one way or another. And we are pleased to see that the Treasury agrees with our position that all of this adds up to a big zero. Most likely, there would be some short-term revenue gain from the legislation from preventing the kind of disruption in the flow of business associated with this change in regulations, but in the long run, there would be very small effect and quite possibly a gain from the legislation.

What might be more useful at this point is just to make an overall comment on this Treasury testimony. Basically what the Treasury told you about this issue was a finely spun out legal theory. One could look at the whole variety of business transactions involving the provision of property. At one end, something is clearly a sale; at the other end, something is clearly a lease. Now in between you can spend a lot of time drawing finely legal lines. What impresses us is that it doesn't really make much difference from a tax standpoint which way you do this. In the motor vehicle area, one way of doing it has been followed for a long period of time.

There is the problem in a lease arrangement of getting the lessee to take proper care of the vehicle. There are a variety of ways of doing this. You can have what are called wear and tear clauses in a lease which try to guess at the effect of certain maintenance, or you can have what seems to be a rather neat economic adjustment which actually looks at the resale value of the car at the end of the lease.

Now since there are good reasons for leases, it seems that there is no social benefit involved in turning a pack of lawyers loose to change things around by reducing just where in this continuum of possible contract clauses, suddenly a light goes on and says this is no longer a lease, this is a conditional sale. This is a sensible business arrangement. The whole tax law is going to work about the same way, whether you change their tax treatment or not. And for this reason, we have not found any sensible reason for the Treasury wanting to pursue this kind of legal theorizing to the point of upsetting an established business practice. Thank you.

[The prepared written statement of Dr. Brannon follows:]

Statement of Gerard M. Brannon, Ph.D, Economic Consultant to ad hoc tax group of U.S. motor vehicle lessors, manufacturers, workers, dealers, and consumers before the Committee on Finance Subcommittee on Taxation and Debt Management at June 7, 1983 Public hearing on S.11.61

I am Gerard M. Brannon. I have been retained by the law firm of Piper & Marbury in behalf of a number of motor vehicle lessors to provide revenue estimates and related economic analysis of changing the treatment of certain arrangements called "TRAC leases", for tax purposes from leases to conditional sales. This is the change that would be foreclosed by S.1161. In this project, I have worked with Emil Sunley who agrees with the testimony that I shall give.

Both Sunley and I have been involved in the tax legislative process, and in the revenue estimating process, from the government side. Each of us was at one time in charge of the economic analysis staff that reports to the Assistant Secretary of the Treasury for Tax Policy. Brief biographies are attached.

This personal background is relevant because before I get into detailed analysis of the revenue forecast, I want to offer an overall assessment of the revenue and economic issues which can be summarized in 5 points:

(1) In the long run, depending on some very fine details that no one can pin down now, there could be some minute

revenue gains or losses to the Treasury. I think that on balance passage of the bill would be a slight revenue gain to the Treasury but I have seen a Treasury estimate of a slight revenue loss of about 1/3 of one percent of the annual depreciation on leased motor vehicles. This is trivia.

(2) In the short run, it seems very clear that the Treasury regulation which would be forestalled by S.1161 would disrupt business practice and thereby reduce GNP and Treasury revenues.

(3) In the long run, it seems clear that a major result of this Treasury regulation would be the increased use of a technically less efficient contract form. This involves some economic waste.

(4) I am at a loss to understand what social benefit Treasury could achieve by the regulation.

(5) The earlier judgments assumed prospective application of a new regulation in which prices are adjusted for the situs of tax benefits. If Treasury were free to change tax rules retroactively, there could be some net gain. You pursue the deficiency cases and hope that other taxpayers don't know to apply for refunds. This is a lousy way to run a tax system.

The reasoning behind these judgments is that what is mainly involved in this matter is which of two taxpayers gets the depreciation deduction and the investment credit. You should recall that only two years ago it was the policy decision of this Congress that there would be a net economic gain to the country if business taxpayers were given a completely unrestricted opportunity to sell depreciation deductions. That decision about safe harbor leasing was partly reversed last year but it was a close call.

What we have in the present issue is, in probably 95% or more of the cases, a matter of upsetting well established business practices to no avail because the user will get the same benefit from tax depreciation that the provider got. There is some revenue loss and inefficiency in messing around this way. In some tiny minority of cases, you may get the result that some extra deductions are pushed to where they do no good. This is what you didn't want to happen in 1981 and what you were uncertain about in 1982. Whether it happens or not in a few cases is no excuse for upsetting a well established practice.

It is not my purpose to develop at length the reasons for or against S.1161, but I did want to present this overview of the kind of legislative question that is at issue. It is necessary, so to speak, to put you into the mood to consider the trivia involved in the revenue estimate.

(1) Directly, S.1161 forecloses a possible Treasury regulation that may or may not be upheld in the Courts. If the

Treasury regulation were contested and defeated, the legislation would have a net gain by foreclosing much fruitless litigation.

(2) Let us assume that without the legislation, a Treasury regulation would have stood up in the courts. All that the regulation does is to provide that a particular form of contract produces depreciation in the hands of the motor vehicle user rather than the motor vehicle provider. Providers could change the contract form, at some real loss of efficiency, or they could go along with the change in situs of the depreciation deduction, with little change in the contract form, other than changing prices.

I limit my economic analysis to the assumption that the Treasury regulation would stand up, so I will comment on the two forms of response.

First, in the short run, both of these changes are disruptive. A change in the situs of depreciation requires a change in the price. When the vehicle provider gets the accelerated depreciation he is willing to take a lower price. If the special tax advantage moves to the vehicle user, the provider will have to raise the price to get in direct payments what he could have gotten in tax benefits. Literally this change in situs involves the car user becoming an investor and may result in running car purchases through the capital budget process where previously a car lease was a routine outlay. In any case, vehicle users will have to go through some coordination with their accounting and tax departments to consider the tax value of depreciation to them and to compare it to the rental increase. All of this could occur when there is uncertainty about how the new regulation will stand up in Court.

A change in the contract form is also disruptive in ways that are fairly obvious. The TRAC lease form was invented to deal with a complex problem, how to assure that the lessor of vehicles would not lose as a result of inadequate maintenance programs by the users. Settling on a less satisfactory alternative, such as closed-end leases with "wear and tear" clauses, involves resetting prices.

Even an average one month delay in the delivery of leased cars could generate a decline in GNP of about $1.2 billion and a revenue loss of $300 million.

In the long run, the pricing change involves a subtle source of revenue loss to the Treasury because the vehicle user must now compensate the provider through larger payments for the tax advantage of depreciation. This means that the basis of the vehicle is larger which increases the amount subject to investment credit and accelerated depreciation. Reasonable calculations suggest that this effect could generate a revenue loss to the Treasury of $85 million a year.

In the long run, a pricing change could lead to some loss of depreciation deductions because some of the lessors of motor vehicles should be exempt organizations that could not use the depreciation deduction. For these cases, we would expect that most often the provider of the vehicles would use a contract form which allowed the depreciation deduction to stay with the provider.

To the extent that motor vehicles are leased long term for personal use, two scenarios are possible. One is as we assumed above, that the contract form would be changed. I understand that a very small (under 5%) portion of long term vehicle leases are for personal, non-business use, and in these cases a TRAC lease is unlikely. Thus, a convenient forecast is that lessors would uniformly switch to closed end leases with no revenue effect.

The other possibility is that the depreciation and investment credit would be lost as the car user becomes "owner". But the car user now qualifies for an interest deduction. The net impact of all this is a potful of pluses and minuses:

(1) the provider loses accelerated depreciation worth about $400, and an investment credit worth about $400;

(2) the provider must raise the price about $1,330 (if he is in 40% bracket) to be able to pay $530 of tax and have $800 net to offset the above losses;

(3) if users continue to lease cars despite the price increase, they would become eligible for an interest deduction costing the government about $1,200 (assuming 35% marginal rate of tax and a 12% stated interest rate);

(4) to the extent that users keep on leasing government gains on balance ($530 + $800, or $1,330 from providers while giving up only $1,200 to users);

(5) to the extent users switch to outright purchase, the government gain is only $800 and the loss about $1,000.

In all this I have made a bushelful of assumptions that could be changed. My guess is that you come out that Treasury wins some and loses some and the whole thing adds up to a fat zero.

In summary, we have attached a short table covering the revenue effects under different guesses about the future.

In the short run, S.1161 produces a revenue gain for the Treasury, either by foreclosing litigation over the regulation or by avoiding the disruption of business practice that adapting to the new rules would entail.

In the long run, the uncertainty is whether business would have adjusted to the regulation by changing the contract form involves some loss of efficiency and some loss of real income in the society and the real value of Treasury tax collections must be lower if the regulation goes into effect (S.1161 thus produces a gain). Letting depreciation go over to the user would result in the loss of depreciation in some cases so the regulation would produce a revenue gain (and S.1161 would mean a loss to Treasury). In the likely development, some of each response, the net revenue effect would be negligible.

By retroactively applying a new regulatory position the Treasury could gain something. This assumes that it would be "successful" in finding autos leased for personal use on audit and collecting the tax and that not many of the users would obtain refunds based on interest deduction. This is an abuse of Treasury power because these transactions would not have been carried out at the historical prices if the lessors had understood the new rules.

Revenue change from S.1161 under alternative scenarios

Scenario	Revenue effect on Treasury Short Run	Long Run
1. Treasury loses litigation on regulation	Gain	0
2. Providers change contract form to closed end-prospective	Gain	Gain
3. Providers change depreciation situs except where user is non-taxable-prospective	Gain	Negligible
4. Providers change depreciation situs in all cases-prospective	Gain	Loss
5. Retroactive application	Lose	Irrelevant

Gerard M. Brannon	Ph.D. Harvard 1950
	Staff economist Joint Congressional Committee on Taxation 1943-9, 1951-57
	Staff economist Ways and Means Committee 1957-1969
	Member Office of Tax Analysis, Office of Secretary of the Treasury 1969-72 Director 1967-69, Acting Director 1969-71
	Professor of Economics, Georgetown Univ. 1972-79. Director Special Studies (Taxation, Pensions, Welfare). American Council of Life Insurance 1979 to date

Senator **DURENBERGER**. Emil, do you want to add any comments?

Mr. **SUNLEY**. Senator Durenberger, I have a written statement which I hope would be included in the record.

[The prepared written statement of Mr. Sunley follows:]

Statement of

Emil M. Sunley

on the Economic and Revenue Impact of

S.1161 Regarding Federal Tax Treatment of TRAC Leases

before the Taxation and Debt Management Subcommittee

of the Senate Committee on Finance

June 7, 1983

I am Emil M. Sunley, Director of Tax Analysis in the National Affairs Office of Deloitte Haskins & Sells, an international accounting firm. I am submitting this statement to you in my capacity as an economic consultant engaged by the law firm of Piper & Marbury on behalf of an ad hoc group of U.S. motor vehicle lessors, lessees, manufacturers, workers, and dealers, on the economic and revenue impact of S.1161 regarding federal tax treatment of TRAC leases.

A lease with a terminal rental adjustment clause (TRAC) is a common form of a motor vehicle lease. In 1981, approximately 4 million vehicles were leased under TRAC leases which allow a rental adjustment at the end of the lease based on the amount realized when the lessor sells the leased vehicle. S.1161 will make clear that a terminal rental adjustment clause shall not be taken into account in determining whether a motor vehicle operating lease is a lease for federal tax purposes.

Section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) provided that a terminal rental adjustment clause should not be taken into account in determining whether a lease for business use is a lease for federal tax purposes. S.1161 would codify the rule of section 210, extend it to consumer leases, and withdraw the restricted power it granted to Treasury to change the rule prospectively by regulation. Treasury, however, has issued proposed regulations reversing the rule of section 210.

Today I want to focus on the economic effects and revenue impact of S.1161. In the case of business leases, there would be no economic effect or revenue impact unless Treasury issues final regulations denying lease treatment for TRAC leases. The question, therefore, becomes what would be the economic effects and revenue impact of the proposed Treasury regulations if Senate S.1161 were not enacted into law.

Treasury's proposed regulations on TRAC leases if adopted as a final rule would cause serious disruptions, both short term and long term, in the automobile leasing and sales markets.

Short Term Disruption

If the Treasury regulation is adopted, effective the date of publication, there will clearly be a significant short term disruption. Contracts would have to be rewritten. Executives within each company would have to consider the new terms and conditions. The path of least resistance for many business vehicle users would be not to take delivery of new automobiles in the interim. Instead these companies would continue to use the automobiles previously leased.

There is probably no way to get a good handle on just how long the short run disruption might last. Given normal "bureaucratic" delays in large organizations, the short term disruption would likely last at least three months. The delay could last as long as six to nine months. Each month delay in replacing leased vehicles would result in a loss of 125,000 new car purchases, having a sales value of $1.2 billion. (This assumes that 3.5 million cars are currently leased to businesses under TRAC leases and that these leased cars turn over on average every 28 months.) A three-month delay would result in a loss of 375,000 new car purchases, with a sales value of $3.7 billion.

In the short-run it is reasonable to assume that a loss in automobile sales translates dollar-for-dollar into a loss of GNP. Thus a loss in automobile sales reduces government revenue. Using the usual Treasury assumption of a 24 percent tax rate on changes in GNP, a one month delay would reduce Federal revenues by $300 million and a three month delay would reduce Federal revenues by $900 million.

Long Term Disruption

In the long term, elimination of TRAC leases would raise the cost of automobiles for business use. Given the higher cost, businesses will use fewer automobiles. How many fewer depends on: (1) the percentage increase in the after-tax cost of using an automobile and (2) how sensitive the demand for automobiles is to an increase in cost. This second factor is usually referred to as the elasticity of demand and is defined as the percentage decrease in demand for a given percentage increase in price. A reasonable estimate of the elasticity of demand for automobiles probably would be 1.0. Given this estimate of elasticity of demand, a 10 percent increase in the cost of automobiles will reduce demand by 10 percent.

Three alternatives need to be considered. First, businesses may continue to lease automobiles, but under closed-end leases. Second, businesses may purchase automobiles outright instead of leasing them. Third, TRAC leases may continue to be used, but rents would be adjusted upward to reflect the fact that the transaction will be treated as a conditional sale for tax purposes under which the lessee/buyer would be allowed the depreciation deductions and investment tax credits.

These three alternatives would have different economic effects on the economy and the leasing industry and would have different impacts on federal revenues. No one at this time can predict just how the leasing industry would adapt if the proposed regulations were issued in final form. A complete analysis of the economic and tax consequences of the proposed regulations would have to consider all three alternatives.

1. Closed-end lease alternative. If businesses switch to closed-end leases, the rentals will have to be higher because the lessor must calculate rentals by reference to estimated rather than actual residuals. A number of leasing companies offer both closed-end and TRAC leases. One company reviewed actual leases for a 1980 model sold in 1982 and a 1979 model sold in 1981. In case of the 1980 model, the closed-end depreciation cost that was built into the lease rate for a closed-end lease was $3,310. When the automobile was sold in 1982 it turned out the actual net depreciation cost was only $2,515. Thus, on the 1980 model a closed-end lease customer would have paid $795 ($3,310 - $2,515) per car more than a TRAC

customer. The spread was only $225 for the 1979 model sold in 1981. This resulted from the weak resale market experienced in 1981.

It should be recognized that closed-end leases have terminal adjustments; namely, "wear and tear" clauses. These clauses protect the lessor from the risk that cars will be returned in poor condition. In theory, they do not protect the lessor from fluctuations in the condition of the resale market. In practice, however, these clauses may provide some protection. When the resale market is strong, lessors may be quite lenient in assessing charges for "wear and tear". But, when the resale market is soft, lessors may fully enforce "wear and tear" clauses.

2. Ownership Alternative. Businesses will lease or buy equipment, including automobiles, depending on which procedure minimizes the cost to capital. Even in a world without taxes, businesses would lease equipment when the cost is less than outright purchase. There are essentially four reasons why a leasing an automobile may be less costly to users than outright purchase.

- The lessor may purchase automobiles in volume at a lower price per vehicle.

- The lessor may be able to sell the automobiles at the end of the lease term at higher prices than the users would be able to sell them.

- The lessor may be able to finance the equipment on more favorable credit terms.

- The lessor may be able to more efficiently manage a stock of automobiles than the user. For example, the lessor may be able more efficiently to title and insure automobiles.

To the extent that the cost of ownership is higher than the cost of leasing, businesses will use fewer automobiles. How many fewer, as indicated above, depends on the elasticity of demand.

There is also an additional effect of switching to ownership. The average holding period for fleet users who own their own fleets is 32 months as compared to an average holding period of 28 months for fleet users who lease their business fleets. Given that 4 million cars and light trucks are under TRAC leases, a lengthening of the average holding period from 28 to 32 months would reduce the annual turnover of leased vehicles by 200,000 units. This translates into a $2 billion annual reduction in new car purchases for business use.

3. Transfer Depreciation Deduction. The third alternative would be to continue to use the TRAC lease but to treat the transaction as a conditional sale for tax purposes. The lessor/seller would have to raise the rentals (or "installment sales payments") to offset the reduced tax shield. The lessee/buyer would claim depreciation deductions and also deduct unstated interest on the "installment sale."

It turns out that this alternative would actually lower the after-tax cost of the lessee/buyer. (This is demonstrated by an example below.) However, a switch to conditional sales still could be disruptive. If the users are treated for tax purposes as purchasers, then the decision to "lease" another automobile would be treated in many firms as a capital budgeting decision. In contrast, under current business practices, replacing leased automobiles is treated as an operating cost.

A switch from a lease to a conditional sale transfers the depreciation deductions to the lessee/buyer. But since the buyer will have a higher cost basis, the amount of depreciation and investment tax credit allowed is increased. The after-tax cost of the lessee/buyer is reduced. The Government comes out behind.

Consider a simplified TRAC lease of a $10,000 automobile with the following terms and conditions: [1]

1. The lease is for 30 months with rental payments of $1,665 at the beginning of each 6 month period.

2. The automobile is placed in service on July 1, 1983.

3. The lessor and the lessee are calendar year taxpayers.

4. The lessor elects to pass through the investment tax credit.

5. The automobile is depreciated as 3-year property.

6. The automobile is turned in and sold on December 31, 1985.

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[1] This admittedly is a simplified example. Rental payments are typically made monthly. The rents charged also must cover the services such as insurance and titling provided by the lessor. All equity financing is assumed. The example, however, captures the essence of the tax issues.

7. The automobile depreciates in value at the rate of 1.8 percent of original cost per month. After 30 months, the automobile is sold for $4,600.

8. The terminal rental adjustment clause assumes that the automobile is sold for $4,600.

If the lessor uses a 12 percent after-tax discount rate, the present value of the after-tax cash flow is just equal to the original investment of $10,000.

The cash-flow from the investment is calculated as shown in Table 1. The addendum to Table 1 indicates the present value of the taxes paid by the lessor is $921.

Now consider a conditional sale. The rentals (or installment payments) are increased by 3.6 percent from $1,665 to $1,725, as shown in Table 2. The present value of the after-tax cash-flow of the lessor/seller is still equal to $10,000. He is just as well off.

Tables 3 and 4 show the after-tax cost of the lessee/buyer. Under a TRAC lease, the present value of the after-tax cost is $3,953 (Table 3), but if there is a conditional sale (Table 4), the present values of the after-tax cost is reduced to $3,902.

How does the Government come out? Under a conditional sale, the Government loses $50 per automobile. Given that 1.7 million cars and light trucks are leased each year, if all TRAC leases are switched to conditional sales, the annual revenue loss would be $85 million.

	Present Value of Taxes
Lease Transaction	
Lessor	$921
Lessee	-3,504
Total	-2,583
Conditional Sale	
Seller	1,190
Buyer	-3,823
Total	-2,633
Difference	-50

Consumer Leases

Section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 provides an interim solution to the problem of how leases of automobiles with terminal rental adjustment clauses should be treated for tax purposes. It only applies to leases in which the lessee uses the vehicle for business, as opposed to personal, purposes. S. 1161, however, is broader than section 210 in that it covers leases for personal use in addition to leases for business use.

Should Treasury be concerned with the leasing of automobiles for personal use? What is the revenue impact of including leases for personal use?

There are no tax advantages for leasing for personal use. The income tax on the income stream from the automobile is zero whether the car is owned outright or leased. If the automobile is owned outright, the imputed income from the ownership of the automobile is not taxed. Put another way, the owner is not required to include in taxable income the imputed return on the capital invested in the automobile.

If, instead, the automobile is leased, the tax law provides capital recovery allowances - depreciation deductions and the investment tax credit - that are equivalent to expensing; that is, the rules for capital recovery provide the same present value of tax savings as would be provided if the taxpayer were permitted to fully deduct the cost of the investment when it is placed in service. Inasmuch as expensing is equivalent to a zero tax rate on the income from depreciable capital, the effective tax rate on the lessor is zero, the same as the effective tax on an owner/user.

The assumption of debt financing does not change the conclusion that there are no tax advantages for leasing automobiles for personal use. Given debt financing, either the lessee/owner or the lessor will get the interest deduction. The tax savings from the interest deduction will be essentially the same because the top bracket tax rate for individuals is about the same as that for corporations.

Leasing of personal automobiles does not involve a revenue loss for the Government. As explained above, the effective tax rate on the income is zero whether the automobile is leased or owned outright.

Conclusion

S.1161 will make clear that a terminal rental adjustment clause shall not be taken into account in determining whether a motor vehicle operating lease is a lease for federal tax purposes. It simply codifies the rule provided in TEFRA and insures that traditional practices in the motor vehicle leasing industry -- practices that predate enactment of the investment tax credit and acceleration of tax depreciation -- continue unless changed by Congress in the future. If S.1161 is not enacted and Treasury issues the proposed regulations in final form, there would be serious short run and long run disruptions to the automobile leasing industry. Assuming most lessors continue to use TRAC leases but treat them as conditional sales, there could even be a long-term revenue loss to the Treasury. One can only wonder what tax policy objectives would be served by forcing the automobile leasing industry to alter its traditional way of doing business.

Table 1

Lease Example
Calculation of Present Value of Lessor's
Cash Flow

Time			Discount Factor	Present Value of Cash Flow
7/1/83	Rent	1,665	1.00000	1,665
12/31/83	Tax at end of 1983:			
	Rent	1,665		
	Depreciation	-2,500		
	Taxable income	-835		
	Tax (46%)	-384		
	Cash flow	384	.94491	363
1/1/84	Rent	1,665	.94491	1,573
7/1/84	Rent	1,665	.89286	1,487
12/31/84	Tax at end of 1984:			
	Rent	3,330		
	Depreciation	-3,800		
	Taxable income	-470		
	Tax (46%)	-216		
	Cash flow	216	.84367	182
1/1/85	Rent	1,665	.84367	1,405
7/1/85	Rent	1,665	.79719	1,327
12/31/85	Regular tax at end of 1985:			
	Rent	3,330		
	Tax (46%)	1,532		
	Cash flow	-1,532	.75328	-1,154
12/31/85	Proceeds from sale	4,600	.75328	3,465
	Recapture tax:			
	Sales price	4,600		
	Adjusted basis	3,700		
	Gain	900		
	Tax (46%)	414		
	Cash flow	-414	.75328	-312
				10,000

Addendum:

Present value of tax payments	
12/31/83	-363
12/31/84	-182
12/31/85	1,154
12/31/85	312
	921

Table 2

Conditional-Sale Example
Calculation of Present Value of the Seller's Cash Flow

Time			Discount Factor	Present Value of Cash Flow
7/1/83	Payment	1,725	1.00000	1,725
12/31/83	Tax at end of 1983:			
	Payment	1,725		
	Cost recovery[1]	1,304		
	Taxable income	421		
	Tax (46%)	194		
	Cash flow	-194	.94491	-183
1/1/84	Payment	1,725	.94491	1,630
7/1/84	Payment	1,725	.89286	1,540
12/31/84	Tax at end of 1984:			
	Payments	3,450		
	Cost recovery	2,609		
	Taxable income	841		
	Tax (46%)	387		
	Cash flow	-387	.84367	-327
1/1/85	Payment	1,725	.84367	1,455
7/1/85	Payment	1,725	.79719	1,375
12/31/85	Final Payment	4,600	.75328	3,465
12/31/85	Tax at end of 1985:			
	Payment	8,050		
	Cost recovery	6,087		
	Taxable income	1,963		
	Tax (46%)	903		
	Cash flow	-903	.75328	-680
				10,000
Addendum:				
	Present value of tax payments			
	12/31/83			183
	12/31/84			327
	12/31/85			680
				1,190

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[1] The original cost of $10,000 is recovered ratably as the five installments of $1,725 and the final installment of $4,600 are received. Cost recovery is equal to 75.614 percent of each payment.

Table 3

Lease Example
Calculation of the Lessee's After-Tax Cost

Time			Discount Factor	Present Value of Cash Flow
7/1/83	Payment	1,665	1.00000	1,665
12/31/83	Tax at end of 1983:			
	Rent	-1,665		
	1/3 of basis adjustment	100		
	Taxable income	-1,565		
	Tax (46%)	-720		
	ITC	-600		
	Tax	-1,320	.94491	-1,247
1/1/84	Rent	1,665	.94491	1,573
7/1/84	Rent	1,665	.89286	1,487
12/31/84	Tax at end of 1984:			
	Rent	-3,330		
	1/3 of basis adjustment	100		
	Taxable income	-3,230		
	Tax (46%)	-1,486	.84367	-1,254
1/1/85	Rent	1,665	.84367	1,405
7/1/85	Rent	1,665	.79719	1,327
12/31/85	Tax at end of 1985:			
	Rent	-3,330		
	Taxable income	-3,330		
	Tax (46%)	-1,532		
	Recapture of ITC	200		
	Tax	-1,332	.75328	-1,003
				3,953

Addendum:

Present value of tax payments

12/31/83	-1,247
12/31/84	-1,254
12/31/85	-1,003
	-3,504

Table 4

Conditional-Sale Example
Calculation of the Buyer's
After-Tax Cost

Time			Discount Factor	Present Value After-Tax Credits
7/1/83	Payment	1,725	1.00000	1,725
12/31/83	Tax at end of 1983:			
	Depreciation[1]	-2,796		
	Taxable income	-2,796		
	Tax (46%)	-1,286		
	ITC[1]	-692		
		-1,978	.94491	-1,869
1/1/84	Payment	1,725	.94491	1,630
7/1/84	Payment	1,725	.89286	1,540
12/31/84	Tax at end of 1984:			
	Depreciation	-4,249		
	Unstated interest[2]	-299		
	Taxable income	-4,548		
	Tax (46%)	-2,092	.84367	-1,765
1/1/85	Payment	1,725	.84367	1,455
7/1/85	Payment	1,725	.79719	1,375
12/31/85	Regular tax at end of 1985:			
	Unstated interest	-1,398		
	Taxable income	-1,398		
	Tax (46%)	-643		
	Recapture of ITC	231		
	Tax	-412	.75328	-310
12/31/85	Recapture tax:			
	Sales price	4,600		
	Adjusted basis[3]	4,252		
	Gain	348		
	Tax (46%)	160	.75328	121
				3,902

Addendum:

Present value of tax payments	
12/31/83	-1,869
12/31/84	-1,765
12/31/85	-310
12/31/85	121
	-3,823

Footnotes on next page.

1] The basis for depreciation and the ITC are determined under the rules for an installment sale using a 10 percent discount rate. The basis adjustment for one-half of the ITC reduces the basis for depreciation from $11,528 to $11,182.

Time	Payments	Discount Factor	Present Value
7/1/83	1,725	1.00000	1,725
1/1/84	1,725	1.00000	1,725
7/1/84	1,725	.90703	1,565
1/1/85	1,725	.86384	1,490
7/1/85	1,725	.82270	1,419
12/31/85	4,600	.78353	3,604
	13,225		11,528
			x .97
			11,182

2] The amount of unstated interest on this installment purchase is $1,697, which is equal to the difference between payments of $13,225 and basis of $11,528. Therefore, 17.361 percent of the last four payments is treated as unstated interest and deducted for tax purposes.

3] Adjusted basis at time of sale is equal to 4,252.

Original basis	11,528
Less ITC basis adjustment	346
	11,182
Less prior depreciation	7,045
	4,137
Plus one-half of recaptured ITC	115
Adjusted basis	4,252

BIOGRAPHICAL SKETCH

Emil M. Sunley joined Deloitte Haskins & Sells in 1981 as Director of Tax Analysis in the National Affairs office. Prior to coming to DH&S, he served as Deputy Assistant Secretary of the Treasury for Tax Policy, 1977-1981. He also served at Treasury from 1968 to 1975 as an economist in the Office of Tax Analysis and later as the Associate Director of that office. From 1975 to 1977 he was a senior fellow in economic studies at the Brookings Institution in Washington, D. C.

Mr. Sunley received his doctoral degree in economics from the University of Michigan in 1968 and graduated from Amherst College in 1964.

Two of his most recent publications are "The Analytics of Safe Harbor Leasing" and "The Proposal for an Alternative Minimum Tax for Corporations", both of which appeared in Tax Notes.

STATEMENT OF EMIL L. SUNLEY, PH. D, FORMERLY DEPUTY ASSISTANT SECRETARY OF TREASURY FOR TAX ANALYSIS

Dr. SUNLEY. I fully agree with the comments that Dr. Brannon has made. And I might at this point only make one comment in relationship to the Treasury testimony presented this morning.

Mrs. Levinson raised the question of whether the Treasury might be whipsawed by different parties of the leasing transaction taking inconsistent positions, in effect, having the lessor treat the transaction as a lease and take depreciation deductions and investment credit, and then possibly having the user claim that it is a conditional sale and also take the depreciation deductions and the investment credit. I would suggest that this possibility, which could indeed involve a revenue problem for the Treasury, is more likely to occur if Treasury continues down the path of issuing the proposed regulation. If that regulation is issued in final form, then it would seem to me that the users or the lessee, could rely on that regulation and say that they have a conditional sale here and take the depreciation and the investment credit. But at the same time, the lessors are going to challenge that regulation. It is not at all clear that that regulation would stand up after it has been litigated. So it seems, if anything, this bill guarantees that the two parties to one of these leasing transactions cannot whipsaw the Treasury. Thank you very much.

Senator DURENBERGER. Thank you. Now we will go to Mr. Nolan.

STATEMENT OF JOHN S. NOLAN, MILLER & CHEVALIER, WASHINGTON, D.C., ON BEHALF OF THE NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. NOLAN. Thank you, Mr. Chairman. I appear today for the National Automobile Dealers Association in strong support of S. 1161. I can summarize our position in a few words, that is, if it ain't broke, don't fix it.

Automobile leases with terminal rental adjustment clauses are transactions that have been shaped in the commercial marketplace. They have been used for decades for sound business reasons as an efficient and extremely effective means of making available the use of automobiles and trucks in the United States. There is no tax avoidance in such leases. For more than 30 years, lessors and lessees treated these transactions consistently as leases. The Internal Revenue Service accepted that treatment and suffered no whipsaw in the process. Thus, the IRS accepted that treatment without question until 1979. It is now seeking to change the long-accepted tax treatment of these transactions as leases.

This change in treatment will seriously disrupt the distribution of new automobiles in the United States at a time when the domestic automobile industry is just beginning to emerge from a disastrous slump. The IRS action will not result in any revenue gain, and the adoption of S. 1161 is necessary to prevent this ill-advised action by the IRS.

I will now depart from my prepared remarks and try to answer the Treasury's points.

In the first instance, it seems strange that the Treasury should come here and damn these transactions by calling them safe harbor leases. For several years now, we have heard the Treasury extol the virtues of safe harbor leasing. In any event, however, that is a complete red herring in this case because these are in no sense comparable to safe harbor leases. These transactions are leases in substance as well as in form. The parties intend them to be leases. The U.S. Tax Court in the *Swift Dodge* case held that they were leases, even though that decision was reversed on questionable grounds by the ninth circuit. The fact that they are, in substance, leases is supported by many earlier decisions of the Tax Court in comparable situations.

They are in no sense comparable or equivalent to a conditional sale. In a conditional sale transaction, there is almost always the trade in of a vehicle or a substantial down payment so that the seller has a security interest of a substantial amount in extending credit to the buyer of the automobile. In a lease transaction, there is no up front payment of that type at all. These are a level series of payments over a period of time. The lessor has no added security interest. The transaction is not comparable to a conditional sale.

The terminal rental adjustment clause is there for the very good reasons that have been outlined on this panel. It is the most efficient means of measuring the actual depreciation in value of the automobile while it was in the hands of the lessee. It rewards the lessee for taking good care of the automobile, and it punishes the lessee for abusing the automobile. That transaction, as I say, has been shaped in the commercial marketplace over a period of more than 30 years without reference to tax considerations.

The Treasury Department in its statement says that it is not true that the open-end lease lowers the cost of the product to the customer. They are wrong. That is why these transactions have been shaped in the commercial marketplace over this long period of time. It is because by this means of using a terminal rental adjustment clause, the parties extinguish from the transaction any contingency allowance going to the lessor to allow for the unexpected or unanticipated misuse or abuse of the vehicle by the customer.

These transactions are efficient means of distributing the use of automobiles and trucks in the United States, and they would not have become so widespread if they were not so effective. They are not based on any considerations of tax avoidance. To the extent that the Treasury shows some ambivalence on that, they are wrong. If the transaction is a business lease, the investment credit and ACRS deductions are going to be worth the same amount to the ordinary lessee as they are to the ordinary lessor.

A personal lease involves different considerations. While it is true that the Treasury's position will result in loss of the investment credit and the ACRS deductions, it is also true, as the Treasury candidly points out in its statement, that it will result in the creation of an imputed interest deduction. Essentially the tax consequences will again be neutral. That is reinforced by the studies that have been done by Dr. Brannon and Dr. Sunley which show that the effect of adopting this bill is revenue neutral.

I conclude by saying that S. 1161 is particularly valuable in settling the tax treatment of these transactions. It will prevent the IRS from interfering with a well established consistent business practice that has proved to be extremely effective. It will codify the tax treatment that has been in effect for more than 30 years. It will recognize the fact that there is no tax avoidance, and it will permit the U.S. domestic automobile industry to move forward in its developing recovery without unnecessary interference with its established methods of doing business. Thank you.

[The prepared statement of Mr. Nolan follows:]

STATEMENT OF JOHN S. NOLAN

IN SUPPORT OF S. 1161, RELATING TO CERTAIN MOTOR VEHICLE OPERATING LEASES

ON BEHALF OF THE NATIONAL AUTOMOBILE DEALERS ASSOCIATION

BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

June 7, 1983

Mr. Chairman, I appear today on behalf of the National Automobile Dealers Association in support of S. 1161. This bill would amend the Internal Revenue Code to make clear that a terminal rental adjustment clause contained in a motor vehicle lease agreement will not be taken into account in determining whether the agreement is a lease or a sale for federal income tax purposes.

Others here today have submitted detailed statements in support of the bill and I will not duplicate their efforts. The sponsors of the bill have included an excellent discussion in support of the bill at pp. S5417-S5424 in the Congressional Record for April 27, 1983 and this deserves careful attention. The purpose of my short statement today is to briefly emphasize several points why the bill should be enacted.

The bill would codify an established tax practice. Over three decades, lessors and lessees have consistently treated motor vehicle agreements with terminal rental adjustment clauses as leases for federal income tax purposes. Indeed, until issuance of the technical advice memorandum in late 1979, the Internal Revenue Service never challenged these transactions as other than leases.

Until perhaps recently, the Service has never been whipsawed by these lease transactions. By seeking to challenge the long-established treatment of these transactions, however, the Service now may have been placed in a position of being whipsawed, and this situation will exist so long as the present proposed regulations under §210 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") remain outstanding. By codifying treatment of these transactions as leases, S. 1161 would resolve this administrative problem for the Service.

Unless S. 1161 is enacted, there will be unnecessary disruption of the motor vehicle leasing industry. Some disruption has already occurred. Some lessors have begun to shy away from these transactions. Leases with terminal rental adjustment clauses are the predominate lease transactions in the motor vehicle leasing industry. They have been shaped in the market place and operate to make vehicles available to lessees at the lowest possible rental. As I have stated earlier, the parties to these transactions have always intended these transactions as leases; this has always been the clear intent of the lenders who provide financing to the lessors in these transactions and who look to the leased vehicle as security for their loans. The proposed change in tax treatment sought by the Treasury and the Service in the proposed regulations will substantially increase the industry's operating costs, result in higher rentals charged for leased vehicles, and result in little if any increased revenue to the Treasury. Certainly this cannot be desirable tax policy.

These lease transactions are not tax avoidance transactions. As indicated above, they are commercial transactions shaped in the market place to accommodate the business needs of lessors and lessees. From the lessor's standpoint, such a lease transaction is entered into to realize an economic profit, not to shelter income from non-leasing activities. Similarly, the lessee is not tax-motivated, but typically enters into these leases to avoid the burdens of ownership, such as, for example, where a large down payment would be required if the transaction, in reality, were a conditional sale. These leases fall in a totally different category from safe-harbor leases, and §210 of TEFRA specifically recognizes these leases as distinguishable from safe-harbor leases and other tax-motivated lease transactions.

The decision of the U.S. Supreme Court in _Frank Lyon Co. v. U.S._, 435 U.S. 561 (1978), is particularly instructive. In this case, the Supreme Court was faced with the issue whether a transaction involving real estate should be recognized as a lease for tax purposes. In deciding that the transaction should be so recognized, the Court stated that where --

> . . . there is a genuine multiple-party transaction [common in the case of motor vehicle agreements with terminal rent adjustment clauses] with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely for tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. . . . (435 U.S. at 583-4).

I respectfully submit that this principle has an important bearing here. Where the transaction cast by the parties is not tax-motivated and is shaped by business or regulatory realities, the transaction should be honored. S.1161 is totally consistent with this Supreme Court pronouncement.

The last point which should be emphasized is that, if these transactions were recast as sales, little or no revenue to the Treasury would be gained thereby. The Treasury revenue estimators, as well as eminent outside economist-consultants to the industry, agree on this point. One such study appears at page S5422 in the Congressional record discussion referred to above.

The needs of this country have been well served for many decades from these extremely useful transactions without tax avoidance. A powerful case therefore exists for the enactment of S.1161 and codification of the established tax treatment of these transactions.

Senator **Durenberger**. Thank you, Mr. Nolan. And let me express my appreciation to all the members of the panel, all of my colleagues who are cosponsors of this bill, particularly my colleagues, Senator Bentsen and Senator Armstrong, who thought they had this job done last year. And let me say to all of you that we are all anxious to have a vehicle to attach this to even if the President isn't. But we will try to move on this just as quickly as possible.

Many of the questions that I might have asked have been answered. And I appreciate the fact that while we are going to have all of your printed statements made a part of the record, that you did address yourselves to the Treasury testimony which I wasn't able to get over to listen to. But just to get everybody into the act—and let me start with you, Dale—I have got an explanation now from both ends of the table here I think on the argument about conditional sales contracts. I wonder if you would add anything to that argument that would fortify the case that you are making?

Mr. **Wickham**. I will add this, Mr. Chairman, in support of what has been said on Treasury's stated position that a motor vehicle TRAC lease is simply a conditional sale. I want to say that the answer to that really is rather straightforward. As a matter of nontax law, it seems to me rather clear that there are a number of factors that distinguish a true lease, such as a TRAC lease, from a conditional sale. And I ought to just spell those out as I see them. I think it may be useful later on.

First, the TRAC lessee has none of the ownership rights that a conditional purchaser usually has in property. Second, the TRAC lessee doesn't make a cash downpayment that is typically required of a conditional purchaser. Third, the conditional sellor has none of the responsibilities imposed on a TRAC lessor by various State and Federal laws in respect to accident liability, State and local taxes, motor vehicle traffic violations, insurance, et cetera. Fourth, the TRAC lessee, unlike the conditional purchaser, does not become the full owner of the property upon making the rental payments required under the lease for the leased term. Fifth, the conditional seller, unlike the TRAC lessor, typically is not personally liable on indebtedness incurred to finance acquisition of the property.

Since the motor vehicle TRAC lease is a true lease under the usual standards that generally apply for nontax purposes, the only question remaining is whether, for purposes of Federal tax law, the Congress should allow a change in the traditional and, as you have heard, longstanding Federal tax law practice, followed both by lessors, lessees and the IRS on audit of tax returns in respecting TRAC leases as true leases under which the lessors are allowed the depreciation deductions and other capital cost allowances provided under the tax laws.

In passing, I should caution against the Congress at any time accepting what seems to be the prevailing IRS presumption that it is either right or desirable to presume that a lease or any other transaction is not what it purports to be, absent some form of sham, tax avoidance transaction. Indeed, I suggest that what I have just said is the view that was laid down by the U.S. Supreme Court in its leading decision in the *Frank Lyon* case as the standard actually to be observed by the IRS.

Motor vehicle TRAC leases, as you have been told, are not tax motivated transactions. The TRAC lease was conceived and is used for sound business cost control purposes, already described by the other witnesses here today, that are important both to the lessors and lessees. So that for Federal tax as well as for nontax law purposes, it seems to me clear that these are not and ought not be treated as conditional sales, but simply as what they purport to be, leases.

Senator DURENBERGER. Let me ask you a couple or three questions to highlight some of this. Isn't it a fact that lessors are considered owners of TRAC leased property under State laws generally in this instance?

Mr. WICKHAM. That is true, Senator.

Senator DURENBERGER. Aren't lessors considered owners for Federal disclosure and recordkeeping purposes not relating to tax issues?

Mr. WICKHAM. That is true.

Senator DURENBERGER. Aren't the lessors personally liable to repayment of any loans used to purchase these vehicles?

Mr. WICKHAM. That is right.

And S. 1161 only applies if there is such liability for financing to acquire the property.

Senator DURENBERGER. Thank you. Let me go back to Mr. Penn. I think Mr. Cartwright when he testified said that the TRAC lease has been in existence as an important part of the industry for something in the neighborhood of 30 years. Is that correct?

Mr. PENN. That is correct.

Senator DURENBERGER. My memory doesn't go back that far, but is he correct in stating that that was long before ITC and ACRS and a variety of other tax benefits?

Mr. PENN. He certainly is. And if you don't mind, Senator, as you said before just to get everybody into the act, if I might refer that question to one of my colleagues behind me just to answer that in a little bit more depth, if Mr. Frank, from Wheels Inc., could answer that question.

Senator DURENBERGER. It doesn't look like he has been around for 30 years. [Laughter.]

Mr. PENN. He is older than I am, Senator.

Senator DURENBERGER. Mr. Frank.

Mr. FRANK. I haven't, but our company was the originator of the leasing industry back in 1939. My father started the industry. And although at that time we were not using TRAC leases, we were using closed-end leases, I think probably because TRAC leases hadn't been invented at that point. Through the war years and thereafter because of the shortage of vehicles available, the lessors were really in a position to dictate what kind of leases were used and the most profitable ones for us. We certainly called them leases because of the shortage of vehicles.

My good colleague's firm introduced the TRAC concept in the late 1940's. It really didn't take off at first, but after a few years when vehicles became available and the marketplace was in a better position to dictate the best type of a lease arrangement as opposed to the lessors, the TRAC lease immediately caught on in the early 1950's and really for competitive reasons because the big users saw the advantages of the TRAC type of leasing in terms of controlling costs and were the most efficient, it just became more and more popular throughout the 1950's and the 1960's and really virtually ever year thereafter has expanded the use. I think it is just universally accepted that that is the most appropriate and most cost effective way of doing business.

Senator **Durenberger**. Thank you, Mr. Frank. Let me just then take that with you, Mr. Penn, and anyone who is sitting behind you just one step farther. I think it was Mr. Weimer who indicated that to his knowledge, there haven't been any arrangements undertaken with TRAC leases simply for tax avoidance purposes. Do you want to comment on that or have somebody comment on that and add to that in effect the answer to the question: Why do companies choose to lease rather than purchase fleets of vehicles?

Mr. **Penn**. Well I think there are a couple of reasons why. And let me take a shot at a couple and then I will as Mr. Goldman, from Bankers Leasing, to help me out on this.

Certainly there is a financial reason in that the companies can conserve their cash, and through the TRAC lease, which is off-balance sheet financing, that they can lease their vehicles and invest their money in those assets within their business that in fact is what they are in business to do, investments in plant and equipment.

Second, the TRAC lease provides the lessee with the opportunity to acquire a book of services that save them a great deal of money: Lower new car acquisition, better used car resale prices, the advice of what to buy, when to replace that vehicle. All of that buying power comes together, so that, in fact, the lessee is not looking at taxes, but is looking at services. Mr. Goldman?

Mr. **Goldman**. Senator, my company, Bankers Leasing, has been in business since 1965. We own about 35,000 vehicles that represent an original cost investment of about half a billion dollars. Our specialty is leasing to public utility companies. We now lease to about one-third of the Nation's public utility companies. And having been associated with the company and in this industry for close to 30 years, I can assure you that the public utility companies who lease motor vehicles generally own the lease under an open-end TRAC motor vehicle clause, and the reason they do so is because they have found it to be the most competitive and the lowest cost form of leasing for these peripheral assets which generally range to about 1 percent of their total assets in place.

We have had a number of utilities, and that represents utility companies virtually in every State in the country, who, in some cases, have gone to their commission either to ask the commission for specific approval or to at least run the transaction by the commission to make sure that there is no objection. And my personal experience has been that in every single instance where a commission has been asked to look at the transactions, in not one case have they ever said it was not the proper way for a utility to go. The reason for it, it is very, very low cost. It is competitive, and there are alternative forms of capital which they have not developed. And we have had lessees that we have dealt with consistently since 1955. Most of our customers have been on our books for 20, 25, or 30 years, using basically the same lease form. They have been solicited by any number of competitors and have constantly come back to this transaction as the lowest cost lease.

Senator **Durenberger**. While you are standing, let me ask you, since you do a lot of utility business, one of the things I was impressed about, only because I didn't realize it I guess, and Mr. Weimer's testimony was that just from a public policy standpoint, if we are interested in fuel savings and incentives for vehicle maintenance and so forth, that lead us to some fuel savings and energy conservation that with the 7,000 vehicles that he leases from somebody, he is doing us a big favor in the TRAC as an incentive to do that. Is that unique to the utility industry or is that common in the case of most large fleet lessees?

Mr. **Goldman**. The utility industry like to control the utilization of their vehicles and the TRAC costs permits them to do that. They may find—for example, their geography is a very narrow area—they may use those cars a little bit longer than someone who has got a vast Western territory with his car piling up an awful lot of mileage. But through the use of the TRAC cost, which gives them in effect a right to control the use of that vehicle as long as it is useful to them in their purpose, they are able to utilize these vehicles in the most efficient manner, and that is what they have done over and over.

Senator **Durenberger**. Thank you very much.

Mr. **Penn**. Senator, the commercial fleet business, was at the forefront of energy conservation in this country when we went through the energy crisis. This industry recommended first 6-cylinder automobiles and then 4-cylinder automobiles, because it could bring to its lessee a lower cost of operating. And if you look at vehicle cost, one-third of our client's cost is depreciation and the other third is running cost; that's gasoline. So as fuel prices went up, this industry, because it is motivated by economics, drove its clients toward more fuel efficient automobiles. That is a part of the service that comes to the fleet industry and to the vehicle industry from vehicle lessors.

One other comment that I might make, and that relates to the 30 years that the TRAC lease has been in place. And tax laws have come and tax laws have gone during that 30-year period of time, and the TRAC lease has stayed in place. I think, Senator, that that is the greatest proof that there is that this is a service-motivated instrument, as opposed to being a tax-motivated instrument.

Senator **Durenberger**. Mr. Frank, were you going to add something?

Mr. **Frank**. I would like to add one point with regard to the question on fuel efficiency. The advantage of the TRAC clause is that the client is responsible both for the depreciation cost as well as the operating cost. And that client, at our suggestion, as Mr. Penn points out, can make a rational decision that says, I ought to replace this vehicle after 18 or 20 months because my savings in fuel efficiency or because I have a safer vehicle or a better vehicle, are more advantageous than some additional depreciation cost that I may incur.

Under a closed-end type of lease, which is a fixed term of 24 or 36 months, the client doesn't have the opportunity to make that kind of decision because the lessor says, wait a minute, I am concerned about my cost of depreciation on this vehicle. I cannot let you replace it at 18 or 20 months. You have got to run the full 24 or 36. You don't get efficient rational decisionmaking under a closed-end, fixed term, I believe, as you do with the flexibility that is provided by the TRAC clause.

Senator **Durenberger**. Thank you. Can any of you recall the IRS attacking these leases prior to 1979?

Mr. **Nolan**. Well, they did not. We had the Technical Advice case that unfortunately resulted in the IRS change of position, and the Service had not attacked these transactions prior to that time. In presenting the issue to the Service, we showed that on three occasions, high officials of the Internal Revenue Service and the Treasury Department had reconsidered the tax treatment of these transactions and had decided not to issue a regulation or a ruling which would change that treatment. In effect, they acquiesced in the well-settled tax treatment that had prevailed all through that period. So for more than 30 years we had a consistent treatment by the IRS of these transactions as leases.

Mr. **Cartwright**. Senator, the only time that they even brought it up was with discussions in the industry in 1968 and 1972 as we found when we were dealing with the technical amendments thing. And they acquiesced. They didn't do anything or take any action to refute the clause at that time.

Senator **Durenberger**. Dale?

Mr. **Wickham**. Senator, I would just like to add to that two points. The Treasury stated in their statement today that this has not been a practice that has been accepted by the IRS on audit. That is simply wrong. As a matter of fact, I think IRS, if asked, would find it very difficult to find more than a case or two in a 30-year period when the question might have even been raised. But I notice that the answer really that's given to the industry's point that it was accepted by the IRS on audit speaks more in terms of what published policy statements are instead of answering the details of what audit practice was. And that is not really responsive.

Moreover, at the policy level of the national office of the Service, I am aware of a case in which one large fleet vehicle lessor had an issue submitted on a request for technical advice involving how to calculate depreciation under the—well, it was under an earlier system of depreciation. There were technical issues about how to calculate it. But it was assumed by the IRS national office in its action on the technical advice that depreciation was allowable to the lessor under the TRAC lease. And I know there have been other instances where there have been issued submitted to the national office for technical advice where, although they have not published their actions on them, they have, in fact, given their rulings, their private rulings, on the assumption that depreciation and investment credit are allowable to the lessor under a TRAC lease.

Senator **Durenberger**. Let me ask one or more of you to comment on one of the views of Treasury, and that is on the adding personal or nonbusiness leases to the business leases. Apparently from the notes that I have been given, Treasury's position is that "subsidies are only allowed for business property, never users using property for personal purposes." Is it appropriate that we include the comprehensive kind of coverage that we have in 1161? And if so, would you justify why we should do so?

Mr. PENN. Senator, we do believe that it is appropriate that we include personal vehicles. Conceptually, we are talking about the same type of arrangement, which is the most cost effective arrangement that you give to the user—in this case, the lessee—who controls the use or abuse of the vehicle.

We also believe that from a revenue point of view, as it relates to the Government, that again this is a revenue neutral issue, and that there are no winners and are no losers. Also, TRAC leases for consumers has also been in place for as many years as it has for fleet vehicles.

We think that from the Government's point of view in trying to police this particular type of arrangement as to where the tax benefits would go, that the Government comes out way ahead by allowing the tax benefits to stay with the lessor as opposed to the lessee.

Senator DURENBERGER. Mr. Wickham?

Mr. WICKHAM. Senator, I might just add two points of law on this question of the coverage by S. 1161 of the consumer leases for personal use. The first is that so far as the Treasury in its statement urges that the lessor be denied the depreciation deduction, investment credit, or other capital cost recovery allowance, by reference to the use of the property in the hands of the lessee, Treasury really is urging upon the Congress a policy that I would caution against accepting. That would make a major change in the law. It has been long recognized that a lessor, who himself is in a trade or a business, and who buys property, is certainly entitled to cost recovery allowances for his investment. And therefore many, many businesses in this country where people are taking depreciation deductions on equipment in which they invested, for purposes of leasing it to individuals or making it available to individuals for personal use in their non-business activities. The Treasury to make this argument in this case without suggesting a broad base change of law, of that kind of highly questionable, I think, and certainly ought not be quickly accepted by this committee. And I don't think it is a valid objection to S. 1161.

Second, I would like to add that from a purely legal standpoint it is hard to justify allowing the IRS's desire to change the law retroactively any more in the case of the leases for personal use than in the case of the leases for business use. Indeed, individual consumers are less able to pay the cost of defending themselves against these retroactive tax deficiency assessments. And I think it is very, very hard to make the case for retroactivity, indeed, for making a change prospective in that area. We really don't see any basis as a matter of law for differentiating the treatment of the two kinds of leases based on the kind of use made by the lessee.

Senator DURENBERGER. Thank you. Mr. Nolan?

Mr. NOLAN. Well I was just going to add to that and reemphasize what Mr. Wickham has said, if there ever was a case of Finn's unlegal theory, this is it, because if there were no TRAC clause in the lease here there wouldn't be any question but that the transaction was a lease and that the lessor could take ACRS deductions and investment credit, even thought the property was leased to a nonbusiness user.

Now the question as to whether this TRAC clause, which has this very limited function of measuring the depreciation that actually occurs in the value of the property while held by the lessee, whether it makes all that difference or not. It doesn't seem to me that that very narrow economic effect of the TRAC clause has should determine whether the lessor in this transaction should get ACRS deductions and ITC. It just doesn't make any sense to me in those circumstances. And as Dr. Brannon has said, you can spend eternities trying to decide at the margin whether a transaction is a lease or a sale, and it is not a very productive kind of inquiry. And where you have a well settled practice, tax-wise and otherwise, that has prevailed for this long, there just isn't any sense in changing all of the rules.

Senator **DURENBERGER**. Thank you. Does anyone else have any comments that need to be added to the record?

[No response]

Senator **DURENBERGER**. If not, the hearing is adjourned.

[Whereupon, at 11:06 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

ALTMAN FOUNDATION
361 FIFTH AVENUE
NEW YORK, N.Y. 10016

June 7, 1983

Senator Bob Packwood, Chairman
Subcommittee on Taxation and Debt
Management
United States Senate
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

We request that the attached written statement be made a part of the record of your Subcommittee hearing on S. 562 held June 7, 1983. The attached written statement sets forth our support for an extension of the time in which certain private foundations must dispose of excess business holdings under Section 4943 of the Internal Revenue Code. We would urge your Subcommittee to revise and broaden the application of the extension of time called for in S. 562 to all private foundations currently required to dispose of excess business holdings.

Thank you for making this written submission a part of the official record of your Subcommittee's hearing on S. 562.

Sincerely yours,

John S. Burke

John S. Burke
President

Dear Mr. Chairman:

S.562, introduced by Senators Percy and Dixon February 23, 1983, would authorize the Secretary of the Treasury to grant extensions of the 5-year period within which certain private foundations must dispose of excess business holdings which they received by gift after May 26, 1969. We believe the Congress should provide an across-the-board statutory five year extension for all private foundations that must, under the various divestiture rules contained in Section 4943, dispose of excess business holdings.

The extension of time we urge you and your colleagues to approve would provide the Congress with a sufficient period of time to thoroughly review whether the rationale for divestiture of excess business holdings by all private foundations continues to constitute sound public policy.

The Altman Foundation is a unique and historic foundation. By will originally dated May 2, 1912, Benjamin Altman provided for the creation of the Altman Foundation. On April 1, 1913, a special Act of the New York Legislature provided for the incorporation of the Altman Foundation. Under its charter the Altman Foundation was formed to provide funds for "charitable, benevolent or educational institutions within the state of New York." The Foundation was first granted tax-exempt status by IRS ruling on June 13, 1919.

Under the will of Benjamin Altman, more than 50 percent of the stock of B. Altman & Co. was transferred to the Altman Foundation. The remaining stock in B. Altman was held by various employees of the Company, received under Mr. Altman's general policy of motivating key employees through employee stock ownership. An additional 360,000 shares was transferred to the Foundation in connection with the termination of a separate foundation set up by former B. Altman & Co. President and employee/shareholder, Colonel Michael Friedsam in the late 1930's. On May 26, 1969, the Foundation held more than 94% of the stock of B. Altman & Co. On that same date, the foundation together with all disqualified persons, held 98.8% of the stock of B. Altman & Co.

Since its creation, the only operating business entity which the Foundation has held has been B. Altman & Co. which operates department stores in and around New York City. (New York City, Manhassat, White Plains, Paramus, N.J., Short Hills, N.J., St. Davids, PA., and Willow Grove, PA.) More than half of the Foundation's income is from dividends on its B. Altman & Co. stock. The balance of the Foundation's income is from dividends on publicly traded securities and interest on corporate and government securites.

The Altman Foundation, under the terms of the will of Benjamin Altman may only make distributions to charities which operate in the State of New York or charities that commit to expend any contributions from the Foundation within the State of New York.

As a result of the Foundation's ownership of B. Altman & Co., the business has remained primarily a New York area business, operated in much the same manner as it has for 118 years, providing high quality merchandise and service to the general public. Its flagship store, occupying an entire square block at Fifth Avenue and Thirty-Fourth Street, has been a local landmark since it first opened in 1906. Should it become necessary for the Foundation to sell its interest in B. Altman & Co., many of the unique local qualities of this retail store could be significantly changed and ultimately lost.

Since 1969 the Altman Foundation has engaged in serious discussions with potential purchasers of B. Altman & Co. in an effort to comply with the Tax Reform Act of 1969. These discussions have involved proposed takeovers by other large regional retailers, acquisition of an interest in B. Altman & Co. by investment groups, and various arrangements with real estate developers seeking to structure ventures which would, as their primary purpose, involve major redevelopment of Altman's main location at 34th Street and Fifth Avenue in New York City.

These efforts have proved to be unsuccessful. Potential purchasers, aware of the Foundation's need to sell the business have made offers which significantly undervalue the assets and operating worth of B. Altman. The trustees, under their fiduciary obligation to the Altman Foundation, could not accept the terms and conditions of the offers tendered or proposed to be tendered.

The Altman Foundation is a unique entity. It was created prior to the enactment of the first Federal estate tax Act to provide funds for "the use and benefit of charitable or educational institutions within the State of New York...".

Since 1917, when the Foundation received its first distribution from the Estate of Benjamin Altman, the Foundation has distributed substantial amounts to charitable organizations in New York. For example, over the years more than $15,000,000 has been distributed to more than 50 charities, including the Federation of Jewish Philanthropies, Catholic Charities of the Archdiocese of New York, Federation of Protestant Welfare Agencies, Inc., New York University, Fordham University, St. Luke's Hospital, St. Vincent's Hospital, the Urban League, the Salvation Army, the Boy Scouts, the Lenox Hill Neighborhood Association, the New York Urban Coalition, Casita Maria, Inc., and the New York Public Library

The Foundation maintains an independent Board of Trustees. Only one B. Altman & Co. official, the Chairman of the Board, also serves as a trustee of the foundation. Only one trustee, the Treasurer, of the Foundation receives compensation for his services and that amount has been fixed at $4,500 for at least the last 35 years. The Secretary to the Foundation receives $4,000 per year. The total expenses of the Foundation (including Federal excise tax) amount to about $70,000 per year of which approximately $20,000 is incurred in connection with the preparation of its annual financial statements and Form 990-PF filed with the Internal Revenue Service. All of the funds received by the Foundation, after payment of its minimal operating expenses and the 2% excise tax ($19,500 for 1982) on its net investment income are distributed each year to the various charities it supports. Charitable contributions in 1982 totaled $790,500.

Given the difficulty in locating potential buyers for B. Altman & Co., the existence of high interest rates which has made such an acquisition less attractive to potential purchasers, the flatness of retail sales over the last few years and the recent sub-par performance level of our economy in general, forcing a sale of B. Altman & Co. at this time would severely devalue the interest of the charitable beneficiaries of the Altman Foundation.

For 70 years, the Altman Foundation has contributed to the well being of the people of the City and State of New York in an exemplary manner. It would be most unfortunate if the Congress of the United States were to now require a "fire sale" of this entity based on policy which appears to be in urgent need of re-examination.

Therefore, we along with the McArthur Foundation and others, strongly urge the members of this Subcommittee and the members of the full Committee on Finance to approve, as soon as possible, a 5 year delay in the divestiture rules applicable to private foundations with "excess business holdings."

It is our firm belief that upon examination, the Congress will conclude that there are certain types of foundations which, for economic and general social reasons, ought to be permitted to continue to hold majority interests in operating businesses.

CHRYSLER
CORPORATION

R. A. PERKINS
VICE PRESIDENT
WASHINGTON OFFICE

June 21, 1983

The Honorable
Bob Packwood
Chairman
Subcommittee on Taxation & Debt Management
Committee on Finance
221 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

Subject: S-1161 Dealing with Motor Vehicle Lease Transactions

Chrysler Corporation supports S-1161, which prevents denial of lease treatment for certain motor vehicle operating agreements, introduced on April 27 by Senators Durenberger, Bentsen, Symms, Pryor, Wallop, Moynihan, Boren, Mitchell, Matsunaga, and Armstrong.

This bill would provide that the presence of a terminal rental adjustment clause ("TRAC") in an agreement shall not be taken into account in determining whether a transaction is a lease. The bill would apply to operating leases of motor vehicles (including trailers) in which the lesee uses the property for either business or personal purposes. However, the bill would not apply to leveraged leases financed with nonrecourse debt. The bill would apply to agreements entered into both before or after the enactment of the bill.

The TRAC lease is not a tax avoidance nor a safe harbor transaction. It was conceived over 30 years ago in an intensively competitive industry for sound business cost control purposes -- important to lessors and lessees. The TRAC lease generally lowers the cost to the user of renting the property, by providing an incentive to the user to maintain the leased property in good condition --thus enhancing its resale value at the end of the lease term. This form of lease is currently used for approximately 4 million vehicles.

Starting in approximately 1979, the IRS changed its audit position regarding TRAC leases. Under its new audit position, the IRS has, both retroactively and prospectively, denied lease treatment to certain vehicle leases containing TRAC clauses and instead treats such transaction as conditional sales.

As part of the Tax Equity and Fiscal Responsibility Act of 1982, signed into law by the President on September 3, 1982, Congress added Section 210, Motor Vehicle Operating Leases, to clarify that the IRS was not to disallow certain TRAC leases retroactively, and could disallow such leases prospectively only under "extraordinary circumstances." As stated in the April 27, 1983 Congressional Record - Senate, page S-5419 -

> "The intent of Congress, however, was far broader than to simply prevent retroactive application of the new IRS audit position. Congress, in enacting Section 210, intended to provide a rule for the future which could be changed by an Internal Revenue Service regulation only under extraordinary circumstances and then only after Treasury and the IRS had completed major policy-level studies that addressed economic issues in addition to addressing technical tax considerations." (Report on the Impact of Proposed IRS Regulations on TRAC Leases, by Emil M. Sunley.)

On November 23, 1982, only 11 weeks after the enactment of Section 210, the Treasury Department issued proposed regulations on a prospective basis which would preclude lease treatment, with respect to any agreement containing a TRAC, and would require the transaction be treated as a conditional sale. Contrary to Congressional intent, Treasury issued its proposed regulations without having conducted the required economic or policy studies.

The position of the Treasury Department that TRAC leases should, for Federal income tax purposes, be treated as conditional sales -

(i) is unsound as a proposed tax policy;

(ii) is wrong as a matter of non-tax law;

(iii) apparently is not based upon a loss of tax revenues; and

(iv) would cause substantial disruption to the industry, without providing any significant benefit to the Treasury or the public.

As stated so clearly by Mr. Sunley in the above cited Report,

> "...The failure of the Treasury to conduct the important policy and economic studies contemplated by Congress ... and the view of Treasury that its proposed regulation is merely interpretative in disregard of the fact that its proposed regulation would reverse a rule of law enacted by Congress, make it necessary and desirable that the power of Treasury to change the rule of Section 210 of TEFRA without Congressional involvement be removed. ..." (Congressional Record - Senate, April 27, 1983, page S-5420)

The TRAC lease is long established and has been respected for over 30 years as a lease for tax as well as non-tax purposes. S-1161 does not create a lease when none exists; it merely prevents the IRS from denying lease treatment to an agreement which contains a TRAC clause. A TRAC lease, under S-1161, would be required to meet all the requirements of the law for qualification as a lease. It would receive neither preferred nor penalty treatment.

The Treasury should not by regulatory fiat, be permitted to overturn an industry practice that has been successfully used for several decades. The characterization of TRAC leases as conditional sales would have an adverse effect upon automobile manufacturers, dealers, lessors, and the millions of vehicle users who depend upon such type leases for cost-effective transportation. This industry can ill afford arbitrary lease restrictions that serve no economic purpose.

We would appreciate your support of S-1161, which would continue the traditional and longstanding tax treatment of motor vehicle leases.

Sincerely,

R.A. Perkins

RAP:pt

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DALE W. WICKHAM

June 10, 1983

Honorable Jackie S. Levinson
Deputy Tax Legislative Counsel
U.S. Treasury Department
Washington, D.C.

Re: Response to Treasury points in opposition to S.1161 (relating to federal tax treatment of open-end motor vehicle TRAC leases)

Dear Ms. Levinson:

This is to respond to several points in opposition to S.1161 that you made for the Treasury Department at the public hearing held on June 7 by the Senate Finance Committee's Subcommittee on Taxation and Debt Management, chaired by Senator Packwood with the assistance of Senator Durenberger.

We submit this in our capacity as counsel to the ad hoc group of motor vehicle lessors, manufacturers, dealers, users, and workers, who also appeared at the same hearing with statements in support of S.1161 that were made after your departure from the hearing room.

We shall focus here only on the 5 key points made on behalf of the Treasury Department that seem to us to be simply wrong or questionable as a matter of public policy.

In summary, those 5 points and our views on them are as follows:

First, you seemed at the hearing to take a position that depreciation tax deductions and investment tax credits ought to be denied to lessors of motor vehicles or other equipment when the lessee of the equipment uses it for personal purposes rather than in a trade or business.

Is a hardware store operator to be denied a depreciation deduction to recover his investment in power lawnmowers or other tools which he bought and financed with debt on which he is personally liable and which he is in the business of renting or leasing for home use because the customer uses the rented equipment for personal purposes? Is an amusement park operator to be denied a depreciation deduction to recover his investment in a ferris wheel which he bought and financed with debt on which he is personally liable because the customer uses the equipment purely for his personal pleasure? In each case the customer certainly is using the equipment for purely personal purposes, and may be assumed to be getting the use of it at a price that will be higher if the hardware store or amusement park business operator is allowed no depreciation deduction; but is it really a Departmental view of the U.S. Treasury that either of those facts has any proper bearing on whether a taxpayer in the business of leasing or otherwise providing equipment for others' use is to be allowed a depreciation deduction to recover the cost of his investment in equipment needed to carry on his business? This seems to us to be indefensible as a matter of public tax policy, whether the point is made only as to leased motor vehicles or is applied generally to all leased property.

Second, your stated position that motor vehicle TRAC leases are conditional sales instead of true leases is wrong as a matter of non-tax law and unsound tax policy. That position relies on a discredited "benefits and burdens" test, long urged by certain IRS personnel, which directly conflicts with a statutorily enunciated policy of Congress as to "net leases". That policy recognizes a net lessor's entitlement to depreciation tax deductions even though the lessor "is either guaranteed a specified return or is guaranteed in whole or in part against loss of income" (IRC §57(d)(1)(B)) via lease provisions shifting to the lessee a variety of cost burdens and risks connected with the leased property.

As a procedural matter, we submit that such a position ought not be allowed to be imposed as a new rule of tax law unless the IRS bears the burden of proving to the Congress that it would be good economic policy and good tax policy for the Congress to change the traditional tax treatment of net leases generally and of net operating motor vehicle TRAC leases in particular.

Third, the position taken is simply wrong in stating that the rule of law proposed in S.1161 is a "guarantee of lease treatment" amounting to restoration for this one exceptional case of "safe harbor" leasing rule that was enacted in 1981 and repealed in 1982. The bill, like section 210 of TEFRA, does not "guarantee lease treatment" of TRAC leases; it prevents a TRAC clause from denying lease treatment but the lease must meet all requirements of law for qualification as a true lease.

Fourth, it again is simply wrong to state that the presence of a TRAC clause in an open-end motor vehicle operating lease does not lower the cost to the user of renting the property.

Fifth, it also is wrong to state that lease treatment for federal tax purposes of open-end motor vehicle TRAC lease agreements is not long established and was not tacitly approved by the IRS or Treasury prior to 1979.

There follows a more comprehensive statement of our immediate response to the positions stated for the Treasury at the hearing.

(1) The suggestion that a business lessor be denied capital cost recovery tax allowances for investments in property leased to others because the lessee uses the property for personal, non-business purposes is indefensible as a U.S. Treasury Department policy.-

In stating opposition to the application of S.1161 to TRAC leases of motor vehicles for non-business use, the following statement was made:

> "We thus oppose extending lease treatment to operating agreements where the vehicles (or other equipment) are not used in a trade or business or for the production of income."

We question whether the Treasury Department really means to espouse a policy that would make the entitlement to tax allowances for recovery of capital costs for a taxpayer engaged in the business of leasing or otherwise providing motor vehicles or any other kind of equipment depend on his customer's not using the equipment for personal or non-business purposes.

(2) The position supporting IRS' efforts to treat open-end motor vehicle TRAC leases as conditional sales is wrong as a matter of non-tax law, is unsound as a proposed new federal tax policy, and is in conflict with the "net lease" policies in both the statute and the IRS' own Rev. Proc. 75-21 ruling guidelines.-

Under the basic standards of non-tax law that apply to distinguish a true lease from a conditional sale the motor vehicle TRAC lease classifies as a true lease for several reasons:

(1) A TRAC lessee doesn't have the ownership rights that a conditional purchaser usually has in property.

(2) A TRAC lessee doesn't make the cash down payment that is typically required of the conditional purchaser.

(3) A conditional seller doesn't have the responsibilities imposed on a TRAC lessor by various state and federal laws in respect to accident liability, state and local taxes, motor vehicle traffic violations, insurance, etc.

(4) A TRAC lessee, unlike a conditional purchaser, doesn't become the full owner of the property upon making the rental payments required under the lease for the lease term.

(5) A conditional seller, unlike a vehicle TRAC lessor, typically is not personally liable on indebtedness incurred to finance acquisition of the property.

Since the motor vehicle TRAC lease is a true lease under the usual standards that generally apply for non-tax purposes, the only question remaining is whether for purposes of federal tax law the Congress should allow a change in the traditional and longstanding federal tax law practice, followed both by the lessors and the lessees and by the IRS on audit of the tax returns, in respecting such leases as ones under which the lessors are allowed the depreciation deductions and other capital cost allowances provided under the tax laws.

In this connection, we would caution against accepting what seems to be the prevailing presumption held by certain IRS personnel that it is right and desirable to presume that a lease or any other transaction is not what it purports to be, absent some form of sham or tax avoidance transaction. Indeed, we suggest that the standard we suggest is the view laid down by the U.S. Supreme Court in its leading decision in the Frank Lyon case as the standard to be observed by the IRS.

Motor vehicle TRAC lease transactions are not tax avoidance transactions. The TRAC clause was conceived and is used for sound business cost control purposes, important both to lessors and to lessees, as was described by the business witnesses at the hearing.

We also would note that the IRS "burdens and benefits" test espoused in the position stated for the Treasury at the hearing presents several major difficulties.

First, it is an attempted end run by the IRS around the Congressionally enunciated policy as to "net leases" which clearly contemplates that a lessor is entitled to depreciation tax deductions and investment tax credits even though he is "either guaranteed a specified return or is guaranteed in whole or in part against loss of income" by lease provisions which shift to the lessee economic risks and burdens connected with the leased property. That policy has appeared in the statute itself, beginning at least as far back as the Tax Reform Act of 1969, in the "net lease" provisions now appearing in Code sections 48(d)(4)(D), 57(d)(1)(B), and 163(d)(4). The burdens and benefits test applied by the IRS in the regulation proposed in November of 1982 as to motor vehicle TRAC leases is in direct conflict with this law. This shows up in Example (1) of that proposed regulation, where the IRS lists taxes, insurance, maintenance and repair expenses, operating expenses, and other particular costs associated with a leased automobile as ones for which the lessee is responsible and then concludes that "under these facts, [the lessor] has not retained significant and genuine attributes of ownership" and that the agreement is not a lease.

The way in whch the IRS would apply its burdens and benefits tests to net motor vehicle operating leases also is contrary to its own policies followed extensively in allowing leveraged "net leases" of major equipment to be treated as leases under its Rev. Proc. 75-21 lease ruling guidelines.

Second, by looking to whether it is the lessee or lessor who pays taxes, insurance, or other particular costs associated with the leased property - instead of to which one bears the burden of such costs - the test urged by the IRS in important cases, treats the lessor as having the burden of costs for the property when he in fact does not; so that the test as applied does not really find "the economic reality" purportedly sought.

Third, even if the test were a true indicator of who has the burdens and benefits, the IRS has not been delegated authority by Congress even to get into the business of using such tests to recharacterize leases as something other than that, absent a clear showing that there is a sham transaction entered into for tax avoidance purposes. As the United States Supreme Court declared in its opinion in the Frank Lyon Co. case:

> "We hold that where, as here, there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory reality is imbued with tax independent consideration, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." (435 U.S. at 583-4) (emphasis supplied).

Finally, even if the IRS' test were modified to correct its deficiencies in looking at who pays instead of who bears costs connected with leased property, and even if the law were changed to permit such a test to be applied to recharacterize leases as something else when there is NOT a sham tax avoidance transaction, it still would present a difficulty that suggests it is fundamentally unsound. We and other analysts of the subject have difficulty finding a single commercial lease transaction that would not be considered to be a sale under the IRS test. The very essence of a lease in Anglo-American commercial and legal tradition, dating from medieval English times to the present, is a "shifting" from the owner-lessor to the user-lessee, during the lease term, of the economic burdens and benefits associated with the property and a termination of the lessee's burdens and benefits at the end of the lease term when the reversionary interest of the owner-lessor takes effect. The mere fact that the IRS test would seem to treat all commercial lease transactions as sales should lead one to question whether there isn't something fundamentally wrong with the test. We suggest that the IRS test is hardly ripe for serious consideration by either Treasury or the Congress.

(3) It is misleading to state that the rule of law proposed in S.1161 is a "quarantee of lease treatment" amounting to restoration of the now repealed safe harbor lease rules for one exceptional class of property.-

An assertion that S.1161 would "guarantee lease treatment" for federal income tax purposes of certain motor vehicle operating agreements appears in the written statement submitted at the hearing for the Treasury no fewer than six times, including the very first sentence, the caption for the discussion of S.1161, and at several other points where it is interwoven into the text of the statement.

S.1161 clearly is not a safe harbor rule. The safe harbor rules enacted in '81 and repealed in '82 treated arrangements that satisfied the safe harbor rules as leases even though they were not. The basic objective of the '81 Act safe harbor lease provisions was simply to permit transferability of unused tax credits and deductions, and the device used for achieving that end was to treat as leases transactions that never would have been thought of as leases. The motor vehicle TRAC lease, by sharp contrast, for more than 30 years had been respected as a lease for tax as well as non-tax purposes. S.1161 does not create a lease when none exists. The agreement must be a true lease. S.1161 merely prevents a true lease from being denied lease treatment because of the presence of a TRAC clause. In other words, where the safe harbor rules in the '81 Tax Act declared any agreement to be a lease if it was called that by the parties and met the few other conditions specified, S.1161 does not declare that the presence of a TRAC clause requires a motor vehicle operating lease to be treated as a lease; it merely prevents the presence of a TRAC clause from being used to deny lease treatment. The agreement must meet all other requirements under law to be treated as a lease.

(4) It also is wrong to conclude that use of a TRAC clause in an open-end motor vehicle operating lease does

not lower the cost to the user for rental of the property.-

The conclusion in the statement submitted for the Treasury that

> "if the value of the property declines below the estimated value, the loss, when added to the rents, should approximate the cost to the customer under a closed end agreement"

ignores several factors. On its face, it ignores the instances where the value of the property exceeds the estimated value and the gain is paid to the customer.

Your written statement offers no evidence of any factual basis to support the assertion for Treasury that open-end leases do not lower cost to the customer. That assertion flies straight into the face of studies and experience of lessors and lessees who have used both kinds of leases for more than 30 years, and ignores the evidence on the hearing record in the testimony offered, after you departed the hearing room, by several industry witnesses who are in a position to know the facts. As those and other industry experts in the past have repeatedly stated, the cost to the user for rental of vehicles necessarily is lower under an open-end lease containing a TRAC clause than under a closed-end lease without such a clause. This is because the direct rental adjustment made by such a clause for the difference between the vehicle resale value initially estimated by the parties and the vehicle resale value actually realized at the end of the lease makes it unnecessary for the open-end lessor to include in the rental a charge for "insurance" against underestimation of actual resale value.

(5) The statement submitted for the Treasury is simply wrong in its factual assertions that lease treatment of open-end motor vehicle TRAC leases is not long established for federal tax purposes and that the practice of the industry in so treating them was not tacitly approved by the IRS and Treasury, and in the implication in its statement that the conditional sale treatment urged by the Service in 1979 in a technical advice memorandum on the audit disposition of one particular case did not represent the beginning of an effort to impose a change in the practice for IRS audit treatment of such leases.-

The United States Tax Court, in the Leslie Leasing Company case, explicitly recognized in its opinion that the IRS had had a longstanding audit position that recognized such clauses as true leases and that the policy change was made without notice to the public or opportunity for public comment. 80 T.C. _____ No.15, at page 19 (typed opinion).

Very sincerely yours,

Dale W. Wickham

Dale W. Wickham

cc: Honorable John E. Chapoton
Assistant Secretary of the
Treasury for Tax Policy
✓ Honorable Bob Packwood
Chairman, Subcommittee on
Taxation and Debt Management,
Committee on Finance,
United States Senate
Honorable Dave Durenberger
United States Senate

June 21, 1983

STATEMENT OF PRULEASE, INC.
FOR
HEARINGS ON S. 1161
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
JUNE 7, 1983

On behalf of PruLease, Inc. (PruLease), a wholly-owned subsidiary of the Prudential Life Insurance Company of America,*/ we are submitting this statement to indicate our strong support of S. 1161. S. 1161 would codify existing law by amending the Internal Revenue Code to make it clear that a terminal rental adjustment clause ("TRAC") contained in a motor vehicle lease agreement is not to be taken into account in determining whether the agreement is a lease or a sale for federal income tax purposes.

PruLease plays a major role in the leasing industry, with motor vehicle fleet leases of over $220 million and leases of other equipment and nuclear fuel with a value of over $355 million. The majority of PruCapital's leases, including all of its motor vehicle leases, contain TRAC provisions. Our analysis indicates that the proposed Treasury position would have a devastating effect on PruLease. PruLease would expect to lose new motor vehicle leasing business of $50 million each year. This represents a loss of 90 percent of expected new business.

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*/ PruLease, Inc. and PruFunding, Inc. are the leasing subsidiaries of PruCapital, Inc., which is a wholly owned subsidiary of The Prudential Insurance Company of America. The term "PruLease", as used in this comment, refers collectively to PruLease, Inc. and PruFunding, Inc.

At the June 7 hearing, witnesses explained in detail the compelling policy and legal reasons for enactment of S. 1161 to prevent the Treasury Department from issuing regulations that would change the longstanding treatment of TRAC motor vehicle leases. We will not review those arguments in detail. However, we wish to emphasize several points for the record.

First, unless S. 1161 is enacted, it can be expected that TRAC leases, which are a valuable tool of American business, will be essentially eliminated. As the witnesses testified at the hearings, TRAC leases have been in widespread use for many years, and they have the important business advantage of offering lower rents than closed-end leases. If the position taken in the proposed regulations were extended beyond motor vehicles, this could virtually eliminate the use of TRAC leases with respect to all types of leased property, resulting in the permanent loss of a valuable business option.

At the hearing, the Treasury Department suggested that the cost to lessees were the same under TRAC leases and under closed-end leases because, at least in the aggregate, the financial burden of both types of leases would be equivalent. This analysis ignores the fact that if lessors are to assume greater risks they will demand risk premiums from lessees. Moreover, even assuming that the analysis were correct, TRAC leases have the beneficial business effect of allocating costs related to poor maintenance or excessive usage to the responsible lessees. That is, under TRAC leases, leased property that is well-maintained and used appropriately will likely be sold for at least its estimated residual value and thus the lessee will be relieved of any additional rental payments. Only those lessees that do not maintain the property adequately or those that use it excessively will be liable to make-up for the reduced sales proceeds at the end of the lease term. Thus, TRAC leases aid economic efficiency by placing the economic burden on the persons responsible for the usage of the leased equipment. This increases the overall efficiency of the use of capital.

Second, the proposed Treasury position would result in no increase in federal revenues and, indeed, would result in a revenue loss. This conclusion was discussed by distinguished economists at the hearing and was not seriously disputed by the Treasury Department witness. As policy matter, this fact is extremely significant where, as here, the proposed administrative position would change widespread business practices that have been in existence for many decades.

Third, contrary to assertions made by the Treasury Department witness at the hearing, the proposed Treasury position is not a correct interpretation of the weight of judicial authority. The leading case in this area is Frank Lyon Co. v. United States, 435 U.S. 561 (1978). In that case, the Supreme Court laid down three requirements for leases to be treated as such for tax purposes. First, the stucture of the transaction must be compelled or encouraged by business or regulatory realities; second, the structure of the transaction must not be a tax avoidance device; and third, the lessor must retain significant and genuine attributes of the traditional lessor status. As indicated above, TRAC leases clearly meet the first two of these requirements since there are substantial business motivations for their existence and taxes are in fact not avoided by entering into TRAC leases. TRAC leases also meet the third requirement in that lessors retain significant and genuine attributes of traditional lessors under a TRAC lease. Among other things, in a TRAC lease, the lessor puts its capital and credit at stake to acquire the property to lease. The liability is disclosed on a lessor's balance sheet, and capital used in the transaction is unavailable for other needs. Equipment lessors invest large amounts of capital and incur large amounts of debt to acquire the property to be leased. Ordinarily the lessor has sole liability for this debt, and ordinarily the debt is "with full recourse." Lessors under TRAC leases treat these items as leases on their books and records and also bear various additional burdens and risks associated with ownership, such as the risk that the lessee will default on the lease payments. In sum, TRAC leases are compelled and encouraged by business realities; they are not tax-avoidance devices; and they do not prevent lessors from retaining signficant and genuine attributes of the traditional lessor status.

In these difficult economic times, with the Administration struggling to pull the country out of a recession, it is baffling that the Treasury Department, in conjunction with the Internal Revenue Service, would go out of its way to propose an unnecessary change in tax concepts that have such a great potential for economic harm. There is no compelling legal or policy reason to change the tax treatment of TRAC leases and thereby end their future use. Rather, there are strong legal and policy reasons to allow their continued use. Therefore, we strongly urge the enactment of S. 1161.

INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA—UAW
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May 31, 1983

Hon. Bob Packwood
Chairman
Subcommittee on Taxation & Debt Management
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Senator Durenberger recently introduced legislation (S. 1161) which would amend the Internal Revenue Code to make it clear that certain motor vehicle operating agreements should be treated as leases for federal income tax purposes. Although we do not plan to testify at the forthcoming hearing on this legislation, the UAW does support Senator Durenberger's bill, and we ask that this communication be included in the hearing record of the Finance Subcommittee on Taxation and Debt Management.

The proposed legislation would add a definitional provision to the Internal Revenue Code specifying that the presence of a terminal rental adjustment clause shall not be taken into consideration in determining whether a motor vehicle operating agreement constitutes a lease for federal income tax purposes. Enactment of this legislation is needed in order to reverse hasty action by the IRS in publishing a proposed regulation which would deny lease treatment to agreements containing such clauses. This IRS action was taken without any of the tax policy or economic or revenue impact studies contemplated under section 210 of TEFRA.

If the IRS action is not reversed, it could have a negative impact on demand for leasing fleets of vehicles. Approximately 4 million vehicles are currently supplied through fleet leases each year, nearly all of which are produced by domestic manufacturers. Studies have estimated that there would be an immediate, one-time decrease of 375,000 in the demand for motor vehicles, and an on-going annual decrease of 200,000, if the proposed IRS regulation were allowed to go into effect. This would inevitably lead to further loss of jobs in the automotive and related industries.

The proposed legislation would not have any adverse revenue consequences for the federal government. Indeed, studies have indicated that, unless it is reversed, the IRS action could actually cost the government several hundred million dollars.

For the foregoing reasons, the UAW hopes Congress will act speedily to enact S. 1161. Your consideration of our views on this issue will be appreciated.

Sincerely,

Dick Warden

Dick Warden
Legislative Director

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cc: Members, Subcommittee on Taxation & Debt Management

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